SUPREME COURT, U.S.

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 19[illegible]

No. [illegible]

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR CERTIORARI FILED JANUARY [illegible]

CERTIORARI GRANTED FEBRUARY [illegible]

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

No. 610

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

INDEX

JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., MAY 18, 1956

—9158-7

[fol. 1] **IN THE TAX COURT OF THE UNITED STATES**

PETITION—Filed April 4, 1952

The above named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency dated January 9, 1952, and as a basis of their proceeding allege as follows:

1. The petitioners are individuals with residence at 434—28th Street, Des Moines, Iowa. The return for the period here involved was filed with the Collector for the District of Iowa.

2. The notice of deficiency, a copy of which is attached and marked Exhibit "A," was mailed to petitioners on January 9, 1952.

3. The deficiencies as determined by the Commissioner are in income taxes for the calendar year 1947 in the amount of $1,411.16, of which approximately $1,411.16 is in dispute; and for the calendar year 1948 in the amount of $2,121.56 of which approximately $2,000.00 is in dispute.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

Error I.

The Commissioner erred in holding that the losses claimed on the return in the amount of $8,492.32 for the taxable year ending December 31, 1947, arising from the worthlessness of notes due Max Putnam by Meredith Case and Leo Quinn, constitute non-business bad debts deductible only as short-term capital losses under section 23 (K) (4) of the Internal Revenue Code.

[fol. 2] Error II.

The Commissioner erred in holding that the loss claimed on the return in the amount of $9,055.21 for the taxable year ending December 31, 1948, arising from payments of principal and interest as guarantor of notes signed by the Whitehouse Publishing Company, constitutes a non-business bad debt deductible only as a short-term capital loss under section 23 (k) (4) of the Internal Revenue Code.

5. The facts upon which the petitioners rely as the basis of this proceeding are as follows:

A. The petitioner Max Putnam is a lawyer, and Elizabeth Putnam is his wife, both residing in Des Moines, Iowa.

B. In the summer of 1946, one of the petitioners, Max Putnam, hereinafter referred to as the taxpayer, represented on a retainer fee a labor union in Des Moines, and through legal labor counselling had become attorney for Leo Quinn, a former business agent of another union, Teamsters Local 90, and Meredith Case, the editor of a labor weekly newspaper. The labor union represented on retainer by taxpayer, Division 441 of the Street Car Men's Union, composed of approximately seven hundred members, was a large subscriber to the weekly newspaper which was known as the Des Moines Federationist.

C. Leo Quinn had started the newspaper and Meredith Case controlled it, and had advertising therefor. They undertook to go into the printing and publishing business with the taxpayer, who put up the money, while they were to get the business and do the work. They persuaded taxpayer that the business would be profitable in itself and would be a valuable asset to his law practice, especially as it would correlate with his legal labor work.

D. A partnership was agreed to at the outset, taxpayer advancing monies to purchase a lot in West Des Moines, Iowa, which is adjacent to Des Moines, Iowa, and taxpayer's residence and legal practice area. A small build- [fol. 3] ing was erected upon said lot at taxpayer's expense in the summer of 1946.

E. The name of the Whitehouse Publishing Company was adopted for the business; a bank account opened under that name with money supplied by the taxpayer, and then Articles of Incorporation were filed in that name August 17, 1946.

F. The purchase of printing equipment was required and the Central National Bank & Trust Company turned down a loan of money on chattel mortgage, either to Quinn or to Case, or to the corporation, or to all three.

G. The contractor who built the building had required the construction contract to be signed by taxpayer personally.

H. Materials and supplies, including paper, newsprint, and metal, had to be obtained on credit which suppliers refused to extend to Quinn or Case or the corporation, or all three.

I. Taxpayer then personally signed a written guarantee to the Newhouse Paper Company in Des Moines, Iowa, for all supplies ordered by Meredith Case, and a written personal guarantee to an association of printing suppliers represented by a Des Moines attorney, Don Neiman, taxpayer personally guaranteeing all suppliers represented by said association. Taxpayer also personally signed and guaranteed a note for $11,000.00 with the Central National Bank & Trust Company on the strength of which credit was granted. That note was paid down and more borrowed on taxpayer's guaranty, ending up in the amount of $9,055.21 which was paid in 1948. All of these obligations were personally assumed by taxpayer in the summer and fall of 1946, both before and after the Articles of Incorporation were filed.

J. Printers were employed on the personal promise of taxpayer that he would pay the salaries if the business didn't, and all printers and employees were union men [fol. 4] belonging to unions who subscribed to the newspaper called The Des Moines Federationist, the name of which was changed to the Iowa Federationist.

K. Case and Quinn were salaried employees, with social security and withholding tax deductions, and so also were all others who worked for the Whitehouse Publishing Company. Taxpayer at no time had a salary or received any income whatsoever from said business.

L. Only $1,500.00 in par value of stock was issued by the corporation. However, more than $9,000.00 in cash of taxpayer was required merely to get the enterprise started; therefore there was no relationship between the stock holdings and monies advanced. The business was contracted for in advance of any stock issue.

M. Leo Quinn and Meredith Case had no monies invested in the enterprise. Each was sold five shares of stock having a par value of $100.00 per share by the execution of a note to the taxpayer, who took an assignment of all of said stock as collateral for the loan. Taxpayer had voting power under an agreement that the two

men were not to get control or ownership of the stock until they repaid their obligations to taxpayer. Both referenced individuals in 1946 signed other notes aggregating $8,492.52, which sums represented a portion of the cash money which taxpayer had put into the business.

N. Taxpayer advanced additional cash each month for all operating expenses. The payroll expense alone averaged more than $2,000.00 per month; all of which was underwritten by taxpayer. To aid in paying bills and payroll Clyde Putnam, Jr., brother of taxpayer, loaned $3,500.00 of the Whitehouse Publishing Company. Five shares of treasury stock were issued to him, the said taxpayer's brother, which represented one-fourth of the outstanding stock. Taxpayer guaranteed this loan also.

O. Each month the expenditures increased until the taxpayer asserted his complete legal control. He discharged Case in February of 1947 and Quinn in June [fol. 5] of 1947. By written instruments executed by Case and Quinn, taxpayer obtained from both of them, release of any claims against or interest in the enterprise. Taxpayer cancelled their notes because both men were judgment proof. Taxpayer then had the corporation acknowledge the obligation to him in equivalent amounts.

P. Within the same year, 1947, the physical assets were sold, including the labor newspaper, and the proceeds of sale were applied to reduce the debts. One remaining asset, a claim against the Breeders Register, was made the basis of a lawsuit, which was dismissed in March, 1948.

Q. The issued shares of stock had been held at all times by taxpayer and pledged as collateral to the bank for loans guaranteed by taxpayer. The bank at all times relied solely upon the taxpayer's signature and reputation for repayment. In 1948 the bank loan was paid in full by taxpayer in the amount of $9,005.21. When said notes were paid the entire printing and publishing business had expired.

R. At all times, from June, 1946, through March, 1948, taxpayer was personally engaged in the said printing and publishing business. Taxpayer spent more time and effort on said printing and publishing business, and the management thereof during 1947, than he did in trying

lawsuits or dealing with clients. As a result the major burden of the legal practice was carried by taxpayer's law partners, Clyde Putnam, Jr. and C. C. Putnam, Sr.

S. Taxpayer entered the said printing business under the assumption that it would be a valuable adjunct to his law practice by and through the connection with the labor movement. After taxpayer was obligated, then, in order to protect his reputation, his relationship to clients, and his personal credit, he had to make good upon all said underwritten obligations, thereby suffering personal losses in 1947 and 1948 of more than the amounts in dispute. The personal involvement of taxpayer in both his law practice and the printing enterprise was complete, such that taxpayer could not afford as a lawyer, to permit the printing business to go into bankruptcy, and could [fol. 6] not avoid the payment of all obligations of the printing business without taking personal bankruptcy.

T. At no time did taxpayer rely upon or enjoy any of the advantages of corporate immunity. At all times insofar as the corporation was involved at all, it was the alter ego and agent of taxpayer. Taxpayer personally conducted the business in all respects and his losses were solely the result of that fact. The business was not conducted by the corporation. The petitioner from the beginning did not elect to conduct the business through the medium of the corporation.

U. Taxpayer attempted to operate this printing business through Case and Quinn. The notes taken from them and the corporation were devices whereby taxpayer attempted to build a printing and publishing business on the efforts of Case and Quinn and on taxpayer's money.

V. Any error in the expression or classification of the deductions which were claimed as bad debts on taxpayer's returns in 1947 and 1948 were the result of taxpayer relying upon others, instead of schooling himself in the regulations and tax law. At all times the facts have been the same, regardless of any misapplied tax terminology in the expression thereof.

W. The loss of $8,492.33 in dispute for the year ending December 31, 1947, was determined to be, and was, final and irrevocable in 1947; and the loss of $9,006.21 in dis-

pute for the year ending December 31, 1948, was determined to be, and was, final and irrevocable in 1948.

X. The losses in dispute were occasioned by the taxpayer not only making the loans and borrowing the money as aforesaid, but also by the taxpayer making more advances and borrowing more money in the personal conduct of a printing and publishing business as a separate personal business, in addition to and as an adjunct of his law practice.

Wherefore, the petitioners pray that this Court may hear the proceeding and allow the deductions claimed by [fol. 7] petitioners for the taxable years ending December 31, 1947 and December 31, 1948, and sustain the assignments of error hereinabove set out.

Max Putnam, Elizabeth Putnam, 434 28th Street, Des Moines, Iowa.

EXHIBIT "A" TO PETITION

Form 1230-A (1951)

U. S. Treasury Department
Office of Internal Revenue Agent in Charge
Omaha 2, Nebraska

Internal Revenue Service
600 Farm Credit Bldg. January 9, 1952.

Mr. Max and Mrs. Elizabeth Putnam
434—28th Street
Des Moines, Iowa

Dear Mr. and Mrs. Putnam:

You are advised that the determination of your income tax liability for the taxable year(s) December 31, 1947, and 1948, discloses a deficiency of $3,532.72 as shown in the statement attached.

In accordance with the provisions ~~of existing internal~~ revenue laws, notice is hereby given to the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with the Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period. [fol. 8] Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to this office for the attention of Conf: 90-D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours, John B. Dunlap, Commissioner, By Arthur J. Berliner, Internal Revenue Agent in Charge.

Enclosures: Statement, Form 1276, Agreement form 870.

STATEMENT

Mr. Max Putnam and
Mrs. Elizabeth Putnam
Husband and Wife
434—28th Street
Des Moines, Iowa

Tax Liability for the Taxable Years
Ended December 31, 1947 and
December 31, 1948

Income Tax

Year Ended-	Liability	Assessed	Deficiency
December 31, 1947	$1,411.16	None	$1,411.16
December 31, 1948	3,487.80	$1,366.24	2,121.56
		Total	$3,532.72

[fol. 9] In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated August 3, 1950, and February 19, 1951; to your protests dated November 3, 1950, and April 20, 1951; and to the statements made at the conferences held in the office of the Internal Revenue Agent in Charge, Des Moines, Iowa, on March 2, 1951, and on June 7, 1951, and at the conference held in the office of the Western District of the Appellate Staff, Omaha, Nebraska, on September 25, 1951.

Adjustment to Net Income

Taxable Year Ended December 31, 1957

Net income as disclosed by return	$ 425.78
Unallowable deductions and additional income:	
(a) Bad Debts	7,492.32
Net income as adjusted	$7,918.10

Explanation of Adjustments

(a) It is held that losses claimed on your return in the total amount of $8,492.32 arising from the worthlessness of notes due you by Meredith Case and Leo Quinn constitute nonbusiness bad debts deductible only as short-term capital losses under section 23(k)-(4) of the Internal Revenue Code.

Computation of Tax

Taxable Year Ended December 31, 1947

Net income as corrected	$7,918.10	
Less: Exemptions (3)	1,500.00	
Balance	$6,418.10	
Tentative tax on $6,418.10		$1,485.43
Less: Tax reduction at 5% of $1,485.43		74.27
Total income tax liability		$1,411.16
[fol. 10] Income tax assessed:		
Original Account No. 9150352		None
Deficiency in income tax		$1,411.16

Adjustments to Net Income

Taxable Year Ended December 31, 1948

Net income as disclosed by return	$ 9,427.81
Unallowable deductions and additional income:	
(b) Bad debts	7,830.21
(c) Rental expenses	484.08
(d) Income from annuity	319.26
Net income as corrected	$18,061.36

Explanation of Adjustments

(b) It is held that the loss claimed on your return in the amount of $9,005.21, arising from the payments of principal and interest as guarantor of notes signed by the Whitehouse Publishing Company, constitutes a nonbusiness bad debt deductible only as a short-term capital loss under section 23(k)(4) of the Internal Revenue Code.

(c) It is determined that your share of the deductible rental expenses attributable to your joint ownership of the O'Malley Apartments (owned jointly with Mr. Karl Burns) is $376.76 instead of $860.84 shown on your return. The difference of $484.08 is restored to your taxable income.

(d) It is held that your income from annuity is taxable income to the extent of 3% of the cost of such annuity. The cost of the annuity was $18,127.00 so that $543.81 (3% of $18,127.00) of the $894.00 you received in 1948 is included in your taxable income by this adjustment.

[fol. 11] Taxable portion of annuity	$543.81		
Reported on your return	224.55		
Adjustment for difference	$319.26		

Computation of Tax

Taxable Year Ended December 31, 1948

Net income as corrected		$18,061.36
Less: Exemptions (3)		1,800.00
Balance		$16,261.36
Joint Return Filed		
One-half of above balance	$8,130.68	
Tentative tax on $8,130.68		$2,004.43
Less: Tax Reduction:		
$ 400.00 at 17%	68.00	
1,604.43 at 12%	192.53	260.53
Tax on one-half of income		$1,743.90
Total income tax liability (1.743.90 multiplied by two)		3.487.80
Income tax assessed:		
Original Account No. 3027841		1,366.24
Deficiency in income tax		$2,121.56

In the Tax Court of the United States

Answer—Filed May 27, 1952

Comes now the Commissioner of Internal Revenue, by his attorney, Charles W. Davis, Chief Counsel, Bureau of [fol. 12] Internal Revenue, and for answer to the petition filed in the above-entitled proceeding, admits and denies as follows:

1. Admits the allegations of paragraph 1.
2. Admits the allegations of paragraph 2.
3. Admits the allegations of paragraph 3.
4. Error I. Denies the allegations of error of paragraph 4 Error I.

Error II. Denies the allegations of error of paragraph 4 Error II.

5. A. Admits the allegations of paragraph 5 A.
B. Denies the allegations of paragraph 5 B.
C. Denies the allegations of paragraph 5 C.
D. Denies the allegations of paragraph 5 D.
E. Denies the allegations of paragraph 5 E.
F. Denies the allegations of paragraph 5 F.
G. Denies the allegations of paragraph 5 G.
H. Denies the allegations of paragraph 5 H.
I. Denies the allegations of paragraph 5 I.
J. Denies the allegations of paragraph 5 J.
K. Denies the allegations of paragraph 5 K.
L. Denies the allegations of paragraph 5 L.
M. Denies the allegations of paragraph 5 M.
N. Denies the allegations of paragraph 5 N.
O. Denies the allegations of paragraph 5 O.
P. Denies the allegations of paragraph 5 P.
Q. Denies the allegations of paragraph 5 Q.
R. Denies the allegations of paragraph 5 R.
S. Denies the allegations of paragraph 5 S.
T. Denies the allegations of paragraph 5 T.
U. Denies the allegations of paragraph 5 U.

[fol. 13] V. Denies the allegations of paragraph 5 V.
W. Denies the allegations of paragraph 5 W.
X. Denies the allegations of paragraph 5 X.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved.

Charles W. Davis, GWR, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: Gene W. Reardon, District Counsel; Melvin A. Bruck, Special Attorney, Bureau of Internal Revenue.

IN THE TAX COURT OF THE UNITED STATES

AMENDMENT TO PETITION—Filed September 23, 1953

The above named Petitioners hereby amend the original Petition herein by adding thereto the following:

6. The Petitioner, Max Putnam, has been engaged in the general practice of law at Des Moines, Iowa, since June 10, 1931. In the course of his practice of law, it was his practice and custom to make investments in various business enterprises from time to time for the purpose of solidifying his relationships with clients engaged in such business [fol. 14] enterprises and for the purpose of encouraging new clients to employ him as their counsel.

7. Petitioner, Max Putnam, loaned money to and advanced funds for the benefit of Leo Quinn and Meredith Case for the purpose, among others, of improving and solidifying his relations with organized labor and with labor unions in the hope and belief that the participation of said Case and Quinn in Whitehouse Publishing Company and Petitioners' loaning of funds to said Case and Quinn would develop relationships with them that would be productive of law business.

8. The original suggestion for the printing enterprise ultimately carried out by Whitehouse Publishing Company was made to Petitioner, Max Putnam, by the business agent for Local 441, previously referred to in the Petition.

9. Petitioner, Max Putnam, acted as guarantor for Whitehouse Publishing Company on its notes to Central National Bank & Trust Company of Des Moines, Iowa, as described in Paragraph 9 of the Petition, for the purpose, among others, of maintaining and improving his relationship as an attorney with organized labor and labor unions, including said Local 441, and for the additional purpose of developing said Whitehouse Publishing Company into a client productive of law business for the Petitioner as general counsel of Whitehouse Publishing Company.

10. The bad debt loss suffered by Petitioner, Max Putnam, on the debt arising from his loaning of funds and his advancement of funds for and to Leo Quinn and Meredith Case arose out of and in connection with said Petitioner's business activity in the general practice of law.

11. The bad debt loss of Petitioner, Max Putnam, in connection with his personal guarantee of the notes of Whitehouse Publishing Company to the Central National Bank & Trust Company, of Des Moines, Iowa, arose out of and [fol. 15] in connection with his business activity in the general practice of law.

Wherefore, the Petitioners pray that this Court allow the deductions claimed by the Petitioners for the taxable years ending December 31, 1947 and December 31, 1948, and sustain the assignments of error set forth in the original Petition herein.

Max Putnam, Elizabeth Putnam, 3819 Amick, Des Moines, Iowa.

IN THE TAX COURT OF THE UNITED STATES

Answer to Amendments to Petition—Filed October 26, 1953

Comes now the Commissioner of Internal Revenue, by his attorney, Kenneth W. Gemmill, Acting Chief Counsel, Internal Revenue Service, and for answer to amendments to petition filed by the above-named petitioners admits and denies as follows:

1. Except that it admitted that the petitioner, Max Putnam, has been engaged in the general practice of law at Des Moines, Iowa since June 10, 1931, denies the allegations of paragraph 1 of the amendments to petition.

2. to 6., inclusive. Denies the allegations of paragraphs 2 through 6, inclusive, of the amendments to petition.

Denies generally and specifically each and every allegation contained in the petition, as amended, not hereinbefore admitted, qualified or denied.

[fol. 16] Wherefore, it is prayed that the determination of the Commissioner be approved.

Kenneth W. Gemmill, (T. A. S.), Kenneth W. Gemmill, Acting Chief Counsel, Internal Revenue Service.

Of Counsel: Frederick M. Seltzer, Acting Regional Counsel; Douglas L. Barnes, Acting Appellate Counsel; Thomas A. Steele, Jr., Acting Asst. Appellate Counsel; Merl B. Peek, Special Attorney; Internal Revenue Service, W-1681 1st Nat'l. Bank Bldg., St. Paul 1, Minnesota.

IN THE TAX COURT OF THE UNITED STATES

Memorandum Findings of Fact and Opinion—May 12, 1954
(Argued September 23, 1953)

Tietjens, *Judge:* The respondent determined deficiencies in income tax against the petitioners of $1,411.16 for 1947 and $2,121.56 for 1948. The questions presented are whether valid debts were created as a result of loans made by the petitioner, and if so, whether the losses from the worthlessness of these debts were incurred in petitioner's trade or business. Certain other adjustments in peti- [fol. 17] tioners' net income for 1948 are not contested. The joint income tax returns of the petitioners, Max and Elizabeth Putnam, were filed with the collector of internal revenue for the district of Iowa.

Findings of Fact

The stipulated facts are so found, and the stipulation and the exhibits thereto are incorporated herein by this reference. The petitioners are husband and wife, and they reside in Des Moines, Iowa. Max Putnam, hereafter called petitioner, is a lawyer and has been continuously in the general practice of law in Des Moines since 1931. Between 1936 and 1941 petitioner was legal counsel to the Hawkeye Casualty Company, a large insurance corporation doing business in Iowa. He bought $19,000 worth of the company's capital stock, and in addition to acting as its legal counsel, petitioner became a director of the company and advised it in its financial affairs. In the 1930's he was a legal representative of the American Farmers Mutual Automobile Insurance Association. In the course of this association he made a loan of $4,000 in 1939 to the general secretary in charge of the company. In 1943 the petitioner loaned $350 to one of his clients,

an inventor, for the development of an invention by the client, and petitioner devoted a considerable amount of time to the promotion of the invention. Between 1951 and 1953 petitioner loaned $800 to a client for the organization of an ultra high frequency television company. He assisted in the organization of the Fortune Laboratories, Inc., an Iowa research and development corporation, and bought $2,350 worth of its stock and was named the corporation's secretary-treasurer. On two occasions in 1951 the petitioner loaned $5,000 to the Modern Lighting and Manufacturing Company, an Iowa corporation, for which he acted as legal counsel. Between 1942 and 1953 he was legal counsel to the Iowa Chiropractors Association. In addition to his legal work for the association petitioner participated generally in the association's activities, and on different occasions he loaned money or endorsed promissory notes for the association. Petitioner was solicited to buy a one-third interest in a pre-concrete [fol. 18] step manufacturing enterprise, but he did not make the purchase, although he subsequently bought stock in this company. Petitioner was legal counsel to the Wilbert Vault Company of Iowa and on one occasion he loaned money to the company's Texas branch.

In 1944 petitioner became legal counsel to Local 441 of a railway workers union in Des Moines and continued as its counsel until 1949. Through the union's business agent he met Meredith Case, editor of the Des Moines Federationist, a weekly newspaper published by the Iowa labor unions, and Leo Quinn, business manager of the Des Moines branch of the Teamsters Union, A. F. of L. With Quinn and Case petitioner formed the Whitehouse Publishing Company in 1946 for the purpose of carrying on a general printing and publishing business. The authorized capital stock of the corporation was 15 shares of a par value of $100 a share. Each of the organizers, petitioner, Quinn, and Case, received 5 shares of stock. As his contribution to the capital of the corporation, and on behalf of Case and Quinn, the petitioner transferred to the corporation a lot worth $1,000 and paid $5,500 to have a building constructed on the lot. The petitioner also made an initial contribution of $1,500 as working capital

for the corporation. He played a principal part in organizing the company and in carrying on its business, and personally guaranteed payment of all supplies purchased by Whitehouse and guaranteed payment of the salaries of the company's employees. On August 20, 1946, the petitioner and Whitehouse borrowed $12,075 from a bank for the use of the corporation and signed a promissory note for the amount as co-makers. Payments were made on this note and its principal reduced to $3,500 by July 30, 1947. In October of 1946, Quinn and Case made conditional transfers of their shares of stock to petitioner, title to the shares to be transferred to petitioner if they failed to meet the payments on any of their promissory notes to him. Quinn and Case contributed none of their own money to the capital of the corporation or to its operating expenses, since they had no funds other than [fol. 19] those necessary for their daily living expenses, but they gave the petitioner promissory notes for his contributions on their behalf. November 1, 1946, Quinn and Case each executed a promissory note to petitioner for $3,070.85, and on November 13, 1946, each executed a promissory note for $1,175.31. These four notes totalled $8,492.32, and represented for each of the makers an amount equal to one third of the cash and cost of real estate transferred by the petitioner to the Whitehouse Publishing Company on or before November 13, 1946. On November 13, 1946, petitioner borrowed $3,500 and made it available to the corporation. In February 1947 Case's notes to petitioner were cancelled and his stock in Whitehouse assigned to the petitioner. In lieu of Case's notes the petitioner was to receive promissory notes for the same amount from Whitehouse. In March, 1947, the petitioner and Whitehouse borrowed $5,000 from a bank and signed a promissory note for the amount as co-makers. In July, 1947, Quinn's notes to petitioner were cancelled and his stock in Whitehouse assigned to the petitioner. In lieu of Quinn's notes the petitioner was also to receive promissory notes for the same amount from Whitehouse. Neither Case nor Quinn was able to repay his debt to the petitioner. By the middle of 1947 it was evident that the publishing venture was unsuccessful. In July, 1947, Whitehouse's only substantial assets were its building

and equipment, and it was receiving some income from payments on purchase orders for a publication it had printed. At the same time it had a $13,500 indebtedness. In July, 1947, Whitehouse sold its building for $7,000 and ceased to do business. Of this amount $5,000 was used by the corporation toward paying off its promissory note of August 1946, and $2,000 went to petitioner to pay him for his advances to the corporation. In December, 1948, the petitioner paid the $3,500 indebtedness remaining on the August 20, 1946 promissory note, and at the same time he paid the $5,000 promissory note of March, 1947.

On his 1947 income tax return, filed jointly with his wife, the petitioner claimed as a business bad debt deduction $8,492.32, the total amount of the promissory notes given to him by Quinn and Case.

[fol. 20] On his 1948 income tax return, also filed jointly with his wife, the petitioner claimed a business bad debt deduction of $9,005.21, which consisted of the $8,500 paid by him on the promissory notes of August 20, 1948, and March, 1947, executed by him and Whitehouse as comakers, together with the interest on these notes.

Opinion

In computing net income the Internal Revenue Code permits the deduction of bad debts that became worthless within the taxable year. Section 23 (k) (1). In the case of an individual taxpayer the amount of the deduction is made to depend on the manner in which the debt became worthless, or on whether the debt is evidenced by a security. If the worthlessness was incurred in the taxpayer's trade or business, the whole amount of the loss is deductible; if not incurred in the taxpayer's trade or business, the loss is treated as a short-term capital loss. Section 23 (k) (1) and (4).

The petitioner's argument is that the debts in question became worthless in his business, since the recipients of his loans were generally his clients, and he hoped by his loans to strengthen his business relationships with them and to contribute to the possibility of increased law business for himself. Alternatively, he suggests that the amounts in question be treated as ordinary and necessary

business expenses under section 23 (a) (1) (A) of the Code; or as losses incurred in business or in transactions entered into for profit, though not connected with business (Section 23 (e) (1) or (e) (2)). In opposition the respondent makes the following contentions: (a) the contributions to capital made by the petitioner on behalf of Quinn and Case did not create valid debts, because the petitioner could not have reasonably expected to be repaid since neither of these men had any funds other than those necessary for their daily living expenses; (b) the petitioner's paying off the bank loans made to Whitehouse did not give rise to debts owed to him, since he was a co-maker of the promissory notes given to the lending bank and hence was primarily liable for the amounts of [fol. 21] the loans; and (c) if valid debts are found to exist, they are non-business debts because they were not incurred in any business of the petitioner.

While it is true, as petitioner admitted in his testimony, that at the time of his advances to the capital of the corporation on behalf of Quinn and Case, they had no substantial funds other than those necessary for their daily living, it does not follow from this that valid debts could not have been created. Although Quinn and Case admittedly had no substantial tangible assets, they were to go to work for Whitehouse and to contribute their experience to the undertaking. Case had been editor of a weekly labor newspaper in Iowa, and Quinn was an experienced union official. It seems to us that the petitioner had good reason to anticipate success for the publishing venture and consequently to expect that he would be repaid by Quinn and Case. Cf. *W. F. Young, Inc.* v. *Commissioner*, (C. A. 1, 1941) 120 F. 2d 159, and cases there cited. More troublesome, however, is the petitioner's later treatment of these debts. In February and July 1947, Quinn and Case each executed an "Assignment, Bill of Sale & Release" by which they transferred outright to the petitioner their shares of stock in Whitehouse in return for his cancellation of their indebtedness to him; in addition the petitioner was to receive promissory notes from Whitehouse in the same amounts as the Quinn and Case notes. It does not appear whether this obligation was ever acknowledged on behalf of White-

house or whether such notes were ever received from the corporation. Despite this attempted substitution of debtors the petitioner was not much better off, since by mid-July 1947 Whitehouse was in poor financial condition. At this time the corporation's only substantial assets were its building and equipment, and it was receiving some income from payments on purchase orders for a publication it had printed. At the same time it had a $13,500 indebtedness on its promissory notes to a bank. In July 1947 Whitehouse sold its building and used most of the proceeds of the sale as payment on one of its promissory note obligations. By this time it was evident that the publishing venture was not successful and that the cor- [fol. 22] poration was insolvent. Therefore, whether Quinn and Case or Whitehouse be considered as the debtor, we are of the opinion that the debts arising out of the petitioner's advances to the capital of Whitehouse on behalf of Quinn and Case became worthless in 1947.

In order to obtain bank loans for Whitehouse it was necessary that petitioner sign promissory notes for the amount of the loans as co-maker with the corporation, and as such he, together with the corporation, was primarily liable on the notes. The petitioner, while acknowledging that he signed the notes as a co-maker, argues that it was understood that Whitehouse was to be primarily responsible for the repayment of the loan, and that he was acting only as a guarantor of the corporation's obligation. Considering that the money loaned was used for ~~the~~ business of the corporation and that the granting of the loan would have been unlikely without the petitioner's signature as co-maker, we think it is reasonable to infer that it was understood that Whitehouse was to be primary obligor on the notes, and that if the petitioner were required to pay, he would be reimbursed by the corporation. In December 1948 the petitioner paid off the two notes that he signed as co-maker with the corporation. Thereupon Whitehouse's obligation to reimburse ~~him~~ came into being, and since the corporation was insolvent, this debt was worthless at its origin. *Shiman* v. *Commissioner,* (C. A. 2, 1932) 60 F. 2d 65. The respondent nevertheless contends that since one of the two notes paid by the petitioner in December, 1948, which

renewed an earlier note of March 27, 1947, was executed by the petitioner and Whitehouse as co-makers on September 27, 1948, when the corporation was hopelessly insolvent and not doing business, although still in existence, the petitioner cannot claim to be a guarantor on this note since at the time he signed there was no possibility of his being reimbursed by the corporation. We see no merit in this argument. The petitioner has established that at the time the original note of March 27, 1947, was signed by him and Whitehouse as co-makers, it was understood [fol. 23] that he was acting as a guarantor. We do not think that the petitioner's signing a renewal note on September 27, 1948, as co-maker with Whitehouse should disturb his guarantor status, since in practical effect the later note created no new obligation but merely extended the time of payment of the original note.

Having decided that the debts owed to the petitioner by Quinn and Case and by Whitehouse were valid debts and that these debts became worthless in 1947 and 1948, there remains the question of the nature of the debts: whether business or non-business. As previously indicated the petitioner contends that his financing clients was a part of his law business, and in support of this argument he testified to various instances in which he loaned money to clients and actively participated in the promotion of their business enterprise. "Business" as used in section 23 (k) (1) and (4) means an occupation to which the taxpayer regularly devotes his time, effort and money in order to earn his livelihood or as a means of acquiring wealth. It does not include isolated transactions, even though they are entered into for profit and are business transactions in the usual sense of the word; nor does it include taking care of one's own investments (*Higgins* v. *Commissioner*, 312 U. S. 212 (1941), rehearing denied, 312 U. S. 714), or carrying on the business of a corporate enterprise (*Commissioner* v. *Smith* (C. A. 2, 1953) 203 F. 2d 310, certiorari denied, 346 U. S. 816 (1953)), no matter how much time is devoted to these activities. In order to meet his burden of proof the petitioner has demonstrated that between 1936 and 1948 he made approximately nine loans to his clients, including the six loans in question here. He also referred to two

other loans but did not specify when they were made. The petitioner mentioned that he bought shares of stock in a few of his corporate clients and that he was asked to invest in a company to manufacture concrete steps. We do not think that this demonstrates a sufficient activity on petitioner's part over a period of twelve years to warrant a finding that he was regularly engaged in financing his clients. Cf. *A Kingsley Ferguson* (1951) 16 T. C. [fol. 24] 1248, (taxpayer's appeal to C. A. 6 dismissed for want of prosecution, December 16, 1952); *Henry E. Sage*, (1950) 15 T. C. 299; Vincent C. Campbell, (1948) 11 T. C. 510. The petitioner devoted a considerable amount of his testimony to describing his work on behalf of his clients, most of which were corporations. Some of the work he described was closely related to his financing activities, but most of it was either the customary services of a lawyer to his client or was the business of the corporate client being carried on by the petitioner.

Accordingly we find that the debts of Quinn and Case, which became worthless in 1947, and the debts of the Whitehouse corporation, which became worthless in 1948, were non-business debts. Having thus characterized these debts, there is no need of our considering the petitioner's alternative arguments.

Decision will be entered for the respondent.

IN THE TAX COURT OF THE UNITED STATES

Decision—May 13, 1954

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion, filed May 12, 1954, it is ORDERED AND DECIDED: That there are deficiencies in income tax of $1,411.16 and $2,121.56 for the years 1947 and 1948, respectively.

IN THE TAX COURT OF THE UNITED STATES

Petition for Review—Filed August 9, 1954

Taxpayers, the Petitioners in the above cause, by Richard E. Williams, counsel, hereby file their Petition for Review by the United States Court of Appeals for the Eighth [fol. 25] Circuit of the decision by the Tax Court of the United States rendered on May 13, 1954, T. C. Memorandum 1954-37, determining deficiencies in the Petitioners' federal income taxes for the calendar years 1947 and 1948 in the respective amounts of $1411.16 and $2121.56, and respectfully show:

I

The Petitioners, Max Putnam and Elizabeth Putnam, are husband and wife, and are individual taxpayers residing in the City of Des Moines, Iowa. The Petitioners filed their joint personal income tax returns for the calendar years 1947 and 1948 with the Collector of Internal Revenue at Des Moines, Iowa, which Collector's office is located within the jurisdiction of the United States Court of Appeals for the Eighth Circuit. This Petition for Review is filed in accordance with Section 1141(b) (1) of the Internal Revenue Code.

II

Nature of the Controversy

The controversy involves the proper determination of the Petitioners' liability for federal income tax for the calendar years 1947 and 1948. Petitioner Max Putnam is and was, during the calendar years 1947 and 1948, an attorney practicing law in the City of Des Moines, Iowa. His clientele was diversified and included manufacturing concerns, insurance companies, professional organizations, partnerships, individuals, and units of organized labor, including Local 441 of a railway workers' union, which Union had, over a period of years, paid very substantial fees to the Petitioner. As attorney for Local 441, Petitioner was required to collaborate with the business agent and directors of the Union, propose and negotiate contracts relating to wages and working conditions, solidify internal strength of the Union, maintain proper relations

between the employer and the Union members, and act as public relations representative of the Union. Petitioner's employment by the Union resulted from his relationships with one Gilbert, business agent for the Union. [fol. 26] In 1945 Gilbert suggested that the petitioner interest himself in the publication of a labor newspaper in Des Moines, Iowa, of the purpose of solidifying internal strength of the Union, developing cooperation between Local 441 and other Unions, and for the betterment of public relations. Gilbert introduced Petitioner to one Meredith Case, editor of the Des Moines Federationist, a weekly labor newspaper, which paper had the endorsement of the local trades and labor assembly, but which was controlled by one Leo Quinn and other Union interests. Quinn was business agent for a large teamsters' local which was affiliated with the international teamsters' union, a branch of the American Federation of Labor.

A corporation was formed for the purpose of publishing local newspapers under the name of Whitehouse Publishing Company. Whitehouse Publishing Company was incorporated on August 17, 1946, and five shares of its capital stock were issued to Petitioner, Max Putnam, a similar amount to Quinn, and a similar amount to Case. Petitioner Putnam transferred to Whitehouse Publishing Company certain real estate and certain sums of cash as consideration for the issuance of said stock. Case and Quinn each agreed to execute, and did execute, to Petitioner Putnam their promissory notes, each equal to one-third of the cost of the real estate and the cash transferred by the Petitioner to Whitehouse Publishing Company. The notes executed by Case and Quinn on November 1, 1946, and on November 13, 1946, aggregated the sum of $8,492.32. All of said notes were secured by the pledge of the stock owned by Case and Quinn in Whitehouse Publishing Company.

On August 20, 1946, and on March 27, 1947, Petitioner Putnam, in order to enable Whitehouse Publishing Company to procure required working funds, guaranteed notes executed by Whitehouse Publishing Company, of Des Moines, Iowa.

During 1947 the debts of Case and Quinn to Petitioner Putnam became worthless. On December 2, 1948, Petitioner

Putnam, out of his own personal funds, paid to Central National Bank and Trust Company the sum of $9,005.21 [fol. 27] in discharge of the balance of principal and interest due to said bank on the notes executed by Whitehouse Publishing Company and guaranteed by Petitioner Putnam. Prior thereto Whitehouse Publishing Company had been fully liquidated, so that on December 2, 1948, it had no assets of any nature or description with which to pay its obligation to Central National Bank and Trust Company, or out of which Petitioner Putnam could recover the amounts paid by him to the bank as guarantor for Whitehouse Publishing Company.

On Petitioners' joint 1947 personal income tax return they claimed as a deduction a business bad debt in the amount of $8,492.32, representing the amount loaned by Petitioner to Case and Quinn.

On their 1948 joint personal income tax return, Petitioners claimed as an ordinary loss the sum of $9,005.21, representing the sum paid by Petitioner to Central National Bank and Trust Company as guarantor for Whitehouse Publishing Company.

The Commissioner of Internal Revenue held that the losses suffered were the consequence of non-business bad debts, and disallowed the deductions claimed on the returns, and determined deficiencies for 1947 and 1948 as aforesaid.

On January 9, 1952, the Commissioner of Internal Revenue mailed Final Notice of Deficiency to Max Putnam and Elizabeth Putnam in connection with his determination of a deficiency in the amount of $1,411.16 for the calendar year 1947, and in connection with his determination of a deficiency in the amount of $2121.56 for the calendar year 1948.

On April 4, 1952, Petitioners filed a petition with the Clerk of the Tax Court of the United States requesting the re-determination of the aforesaid deficiencies. The answer of the Commissioner of Internal Revenue was filed on May 27, 1952.

On September 23, 1953, a hearing was held before the Tax Court of the United States in the court room at the United States Court House in Des Moines, Iowa. On that [fol. 28] same date Petitioner filed an amendment to his petition, to which an answer was filed on October 26, 1953.

On May 12, 1953, the Tax Court of the United States promulgated its memorandum Findings of Fact and Opinion, T. C. Memorandum 1954-37, and on May 13, 1954, the decision of the court was entered.

On June 10, 1954, Petitioners' Motion for Review by the Full Court was denied.

III

The Petitioners, Max Putnam and Elizabeth Putnam, being aggrieved by the Findings of Fact and Conclusions of Law contained in the said Findings and Opinion of the Tax Court, and by its decision entered pursuant thereto, desire to obtain a review thereof by the United States Court of Appeals for the Eighth Circuit.

IV

ASSIGNMENT OF ERROR

The Petitioners assign as error the following acts and omissions of the Tax Court of the United States:

1. The failure to find that the debts of Case and Quinn to the Petitioner and the losses resulting from the worthlessness of such debts were proximate to and were incurred in Petitioner's business as a practicing attorney.

2. The failure to find that the losses suffered by reason of the worthlessness of the debts of Case and Quinn to Petitioner were business bad debts and deductible as losses under Section 23(k)(1) of the Internal Revenue Code.

3. The failure to find that the debt to Whitehouse Publishing Company to the Petitioner, if a debt existed, resulting from Petitioner's payments to Central National Bank and Trust Company as guarantor for Whitehouse Publishing Company, and the losses resulting from the worthlessness of that debt, were proximate to and incurred in Petitioner's business as a practicing attorney.

[fols. 29-55] 4. The failure to find that the loss resulting from the worthlessness of the debt of Whitehouse Publishing Company to the Petitioner, if a debt existed, was deductible as a business bad debt within and under Section 23(k)(1) of the Internal Revenue Code.

5. The finding that a debt arose in favor of the Petitioner against Whitehouse Publishing Company by reason of Petitioner's payments to Central National Bank and Trust

Company as guarantor on the notes of Whitehouse Publishing Company.

6. The failure to find that the losses resulting from Petitioner's payments to Central National Bank and Trust Company as guarantor on the notes of Whitehouse Publishing Company were losses incurred in Petitioner's business, within the meaning of Section 23(e)(1) of the Internal Revenue Code.

7. The failure to find that the loss resulting from Petitioner's payment to Central National Bank and Trust Company as guarantor for Whitehouse Publishing Company was a loss resulting from a transaction entered into for profit, within the meaning of Section 23(e)(2) of the Internal Revenue Code.

8. The findings of deficiencies for the years 1947 and 1948, in lieu of a determination that there is no income tax due from the Petitioners for any of the years in controversy.

Wherefore, it is respectfully requested that the United States Court of Appeals for the Eighth Circuit reverse and remand the decision of the Tax Court of the United States entered herein on May 13, 1954, with instructions to determine that there is no deficiency for the calendar years 1947 and 1948, and that Petitioners have such other and further relief as the Court may deem proper.

Richard E. Williams, 800 Hubbell Building, Des Moines, Iowa, Counsel for Petitioners.

[fols. 56] UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 15,190

MAX PUTNAM AND ELIZABETH PUTNAM, Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition to Review Decision of the Tax Court of the United States

OPINION—August 11, 1955

Richard E. Williams for Petitioners.

Dudley J. Godfrey, Jr., Special Assistant to the Attorney General (H. Brian Holland, Assistant Attorney General, and Ellis N. Slack and Joseph F. Goetten, Special Assistants to the Attorney General, were on the brief), for Respondent.

Before Gardner, Chief Judge, and Woodrough and Thomas, Circuit Judges.

[fol. 57] THOMAS, Circuit Judge:

Petitioners, Max Putnam and Elizabeth Putnam, seek a review and reversal of a decision of the Tax Court of the United States entered on May 13, 1954, sustaining the determination of the Commissioner of Internal Revenue that there was a deficiency in their income tax return for the year 1947 in the sum of $1411.16, and for the year 1948 in the sum of $2121.56.

Petitioners contend here, as they did in the Tax Court, that they were entitled in their 1947 return to a deduction of $8492.32 as a business bad debt deduction under § 23(k)(1) of the Internal Revenue Code of 1939; and in their 1948 return to a deduction of $9005.21 under § 23(k)(1), supra, or as a loss resulting from a transaction entered into for profit within the meaning of § 23(e)(2) of the Internal Revenue Code of 1939. Instead the Commissioner determined that the losses sustained in 1947 and 1948 constituted non-business bad debts deductible only as short-term capital losses under § 23(k)(4) of the Internal

Revenue Code. The Tax Court sustained the determination of the Internal Revenue Commissioner, and thereafter petition to review such decision was filed.

The alleged errors of the Tax Court relied on by the petitioners are that:

The court erred in holding that the debts owing petitioner, Max Putnam, which became worthless in 1947 and 1948 were non-business debts, in that (a) the losses resulting from the worthlessness of such debts were proximate to and incurred in petitioner's business as a practicing attorney; (b) that the worthlessness of such debts (if debts existed) was deductible as a loss under said § 23(k)(1); or (c) that the loss suffered by petitioner as guarantor on [fol. 58] the notes he was compelled to pay resulted from a transaction entered into for profit within the meaning of § 23(e)(2) of said Internal Revenue Code.

Petitioners, husband and wife, reside in Des Moines, Iowa. They filed joint income tax returns for the years 1947 and 1948. Since 1931 petitioner, Max Putnam, has been continuously engaged in the practice of law in Des Moines.

The transaction with which we are concerned resulted from the organization of the Whitehouse Publishing Company. In 1944 Putnam became legal counsel for Local 441 of the Railway Workers Union at Des Moines, continuing in that capacity until 1949. Through one Gilbert, business agent of the union, he met Meredith Case, editor of the Des Moines Federationist, a weekly labor newspaper, which had the endorsement of the local trades and labor assembly, but which was controlled by Leo Quinn, business manager of the Local Teamsters' Union, A.F.L., and other union interests.

On August 17, 1946, the Whitehouse Publishing Company was incorporated for the purpose of carrying on a general printing and publishing business. Its capital stock consisted of 15 shares of the par value of $100 each, five shares of which were issued to petitioner, and five shares each to Case and Quinn. While Case and Quinn had a reputation for honesty and integrity, they had no means or cash available to put into the corporation. For himself and on behalf of Case and Quinn, Putnam transferred a lot valued at $1,000 to the corporation, paid $5,500 for the construction

of a building thereon, and made a cash contribution of $1,500 as working capital. He also guaranteed the payment for supplies purchased by Whitehouse and of its employees' salaries.

[fol. 59] Case and Quinn agreed to and did execute to petitioner their promissory notes, each equal to one-third of the cost of the real estate and the building, and of the cash which Putnam had put into the company. In November, 1946, these notes aggregated the sum of $8,492.32 and were secured by pledge of the Whitehouse Publishing Company stock owned by Case and Quinn. Their debts to the petitioner became worthless in 1947. In February, 1947, Case's notes to petitioner were cancelled and his shares of stock in Whitehouse were assigned to petitioner who was to receive promissory notes in like amount from Whitehouse. In July, 1947, Quinn's notes to petitioner were cancelled and his shares of stock in Whitehouse were assigned to Petitioner, who was to receive notes for the same amount from Whitehouse. Nothing in the record indicates whether petitioner ever received such notes from Whitehouse.

On August 20, 1946, petitioner and Whitehouse Publishing Company borrowed $12,075 from the Central National Bank and Trust Company of Des Moines for the use of the corporation and signed a promissory note therefor as co-makers.

Petitioner, on November 13, 1946, borrowed the sum of $3,500 which he made available to the Whitehouse Publishing Company.

In March, 1947, Whitehouse and petitioner borrowed from the bank the further sum of $5,000 and signed a promissory note therefor as co-makers.

This publishing enterprise was not successful. By July, 1947, the publishing company's only assets were its building and equipment. It was receiving some income from payments on orders for a publication it had printed, but at the same time its indebtedness amounted to $13,500. Its [fol. 60] building was sold for $7,000 and it ceased to do business. From the $7,000 thus received $5,000 was used toward paying off the promissory note of August 20, 1946, and $2,000 was turned over to the petitioner for the advances he had made.

In December, 1948, petitioner paid to the bank the bal-

ance of $3,500 due on the note of August 20, 1946, and the $5,000 note of March, 1957, which notes with interest totaled the sum of $9,005.21.

The pertinent statute in determining the issues here is § 23 of the Internal Revenue Code of 1939 (26 U.S.C., 1952 Ed., § 23), which reads as follows:

"Sec. 23. *Deductions from gross income.*

* * * * * * *

"(e) *Losses by Individuals.* In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

"(1) if incurred in trade or business; or

"(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; . . .

* * * * * * *

"(k) *Bad Debts.*—

"(1) [as amended by Section 124 (a) of the Revenue Act of 1942, and Section 113 of the Revenue Act of 1943] *General rule.*—Debts which become worthless within the taxable year; . . . This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

* * * * * * *

[fol. 61] "(4) [As added by Section 124(a) of the Revenue Act of 1942, supra] *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term 'non-business debt' means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

In this publishing venture which turned out so unfortunately for the petitioner, Max Putnam, there is no ques-

tion but that he sustained the losses for which he claims deductions in the joint income tax returns of himself and his wife for the years 1947 and 1948.

However, the questions we must answer are whether the losses which he suffered were proximate to and incurred in his business as a practicing attorney and whether the balance of the debt he was compelled to pay to the bank was connected with a transaction entered into for profit, or a "non-business" debt.

Petitioner does not contend that he was in the business of investing in, organizing, and financing business enterprises as such. He was a practicing attorney. He contends that all of his activities connected with various enterprises, including the advances and loans to Case and Quinn, were part of his activities as a lawyer directed toward the betterment of attorney-client relationships and for increasing his clientele.

To show that the loss of $8492.32 resulting from the debts owing him by Case and Quinn were proximate to and incurred in his business as a practicing attorney he calls attention to two cases from the Tax Court: *Fisher Brown,* [fol. 62] *et al. v. Commissioner,* 9 T.C. 1045, and *Hogan* v. *Commissioner,* 3 T.C. 691; also cited is the case of *Maloney, Collector* v. *Spencer,* 9 Cir., 172 F. 2d 638. A reading of these cases does not convince us that the situations in them are analogous to the situation here, as petitioner contends. The loans to Case and Quinn were not proximate to or incurred by him as an attorney; they were not essential to his law practice. *Burnet* v. *Clark,* 287 U.S. 410; *Omaha National Bank* v. *Commissioner,* 8 Cir., 183 F. 2d 899. His loss from the debts owing him by Case and Quinn was not "attributable to the operation of a trade or business regularly carried on by the taxpayer." *Dalton* v. *Bowers,* 287 U.S. 404, 409.

In the cases cited, supra, by the petitioner the taxpayers advanced money to or guaranteed loans for businesses which were closely associated with their various business enterprises. For instance, in the *Fisher Brown* case the taxpayer was a wholesale distributor of furniture. He advanced and loaned money to his son-in-law, a manufacturer of furniture. The business failed and taxpayer's loss was treated as a business bad debt under § 23(k)(1) of the

Internal Revenue Code, the Tax Court saying: "We conclude that the petitioner made the advances to Marin as loans for purposes connected with his business as a distributor of furniture . . ." We fail to see the analogy and hold this contention to be without merit.

The facts here bear a striking similarity to the facts in the case of *Omaha National Bank* v. *Commissioner*, 8 Cir., 183 F. 2d 899. There L. R. Crofoot, deceased before the case reached the appellate court, and for whose estate the bank was special administrator, was a practicing attorney in Omaha, Nebraska, during all the period involved. In order to protect loans he had made to one Rosso, a restau- [fol. 63] rant and tavern operator, the business was incorporated with a capital stock of $40,000, and finally the taxpayer owned 333 shares of the stock for which he had paid $33,450. From its inception the business did not prosper, and finally the corporate assets, including the building, were sold for $15,000. After the distribution of the assets there was still owing the taxpayer on money loaned to the corporation the sum of $10,407.90, which he claimed as a business bad debt. The Tax Court held that his losses were not suffered in his "trade or business"; that the petitioner was not engaged in the restaurant business, which was conducted by a corporation; and that it was not his individual business. One of the principal cases relied on by the Tax Court was that of *Burnet* v. *Clark*, 287 U.S. 410, wherein it was said: "The unfortunate endorsements were no part of his ordinary business but were occasional transactions intended to preserve the value of his investment in capital shares." This court affirmed, holding that the loss suffered by the taxpayer was not incurred "in his trade or business." See, also, *Nicholson* v. *Commissioner*, 10 Cir., 218 F. 2d 840; *Chicago Title & Trust Co.* v. *United States*, 7 Cir., 209 F. 2d 773; *Commissioner* v. *Smith*, 2 Cir., 203 F. 2d 310, cert. den., 346 U.S. 816. The loans advanced to Case and Quinn were not business bad debts allowable as deductions under § 23(k)(1), but the loss of the $8292.32 which taxpayer sustained in 1947 constituted a non-business bad debt deductible only as a short-term capital loss under § 23(k)(4) of the Internal Revenue Code of 1939.

Finally we consider whether the losses of petitioner resulted from a transaction entered into for profit within the

meaning of § 23(e)(2), "though not connected with the trade or business."

We have already considered that the loans made to Case and Quinn resulting in the loss of $8492.32 were non-business bad debts deductible as short-term capital losses. These loans cannot be considered as transactions entered into for profit within the meaning of § 23(e)(2). Only if the publishing venture had proved successful would there have been any chance to be reimbursed by Case and Quinn. At no time had they anything of value from which reimbursement could be had. Petitioner admits they were "judgment-proof."

[fol. 64]

We next consider whether the loss which resulted in 1948 comes under § 23(e)(2). In December, 1948, taxpayer was compelled to pay to the bank the sum of $9005.21. The amount represented the balance of $3500 due on the $12,075 note of August 20, 1946, and the $5000 note executed in March, 1947, both of which notes petitioner signed as comaker with the Whitehouse Publishing Company.

Very little discussion is needed on this point. It is true that in the case of *Cudlip v. Commissioner*, 6 Cir., 220 F. 2d 565, that court reversed the decision of the Tax Court. Cudlip was an attorney, and his law practice had to do principally with banks, corporations and business ventures. He became interested in WiRecorder Corporation, and in 1947 with two others he became a guarantor on the corporation's note for $90,000. The corporation was not successful and on November 23, 1949, notified the bank that it was unable to meet its obligation upon the note. Whereupon, in accordance with his guaranty agreement, Cudlip paid the bank on November 25, 1949, $30,000 plus $200 of interest due on the note. The other guarantors likewise paid $30,000 each on the note. The corporation was insolvent; its corporate existence terminated on December 13, 1949; and petitioner Cudlip never recovered anything from the corporation. The Sixth Circuit, reversing the decision of the Tax Court, stated that the loss incurred resulted from a transaction entered into for profit under § 23(e)(2). In its opinion the court said that "Taxation is concerned with realities, and . . . the contentions here advanced by the Commissioner are completely unrealistic," and remanded the case for allowance of the

[fol. 65]

claimed deduction under § 23(e)(2), relying particularly upon *Pollak* v. *Commissioner*, 3 Cir., 208 F. 2d 57, 58, and *Allen* v. *Edwards*, D.C. Ga., 114 F. Supp. 672, 674 (affirmed by the Fifth Circuit in *Edwards* v. *Allen*, 216 F. 2d 794). In a vigorous dissenting opinion, Judge Stewart stated:

"Yet, until the *Pollak* and *Allen* cases, and today's decision in this case, the debt so arising has consistently been considered nonetheless deductible as a bad debt, although it became worthless immediately upon its ripening from a secondary obligation into a debt." Citing cases.

Considerable diversity of opinion exists among the different circuits as to deductions from gross income under § 23 of the Internal Revenue Code. We find no case in the Supreme Court overruling its decision as to a non-business bad debt loss since the publication of its decision in *Burnet* v. *Clark*, 287 U.S. 410. In spite of the recent opinion of the Sixth Circuit in the *Cudlip* case, supra, the great weight of authority is that a transaction such as that of Whitehouse Publishing Company and petitioner with the bank, wherein petitioner was compelled, as co-maker or guarantor, to pay the balance due on the notes to the bank in the sum of $8,065.21, including interest, is a non-business bad debt deductible as a short-term capital loss under §23(k)(4), and that such loss does not come under the provisions of § 23(e)(2) where deduction is allowable "if incurred in any transaction entered into for profit, though not connected with the trade or business." See and compare [fol. 66] *Burnet* v. *Clark*, 287 U.S. 410; *Commissioner* v. *Smith*, 2 Cir., 203 F. 2d 610; *W. F. Young, Inc.* v. *Commissioner*, 1 Cir., 120 F. 2d 159.

The decision of the Tax Court as to a deficiency in the petitioners' income tax returns for 1947 and 1948 in the sums of $1411.16 and $2121.56, respectively, is, therefore,

Affirmed.

[fol. 67] United States Court of Appeals for the Eighth Circuit

Max Putnam and Elizabeth Putnam, petitioners

vs.

Commissioner of Internal Revenue.

Judgment—August 11, 1955

Petition to Review Decision of the Tax Court of the United States.

This cause came on to be heard on the Petition to review a decision of The Tax Court of the United States entered May 13, 1954, determining that there were deficiencies in the income tax returns of the petitioners for the years 1947 and 1948, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the decision of the said Tax Court in this matter be, and the same is hereby, affirmed.

And it is further Ordered by this Court that the petition to review in this matter be, and the same is hereby, dismissed.

August 11, 1955.

[fol. 68] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 69] SUPREME COURT OF THE UNITED STATES

[Title omitted]

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI

Upon consideration of the application of counsel for petitioner(s),

It is ordered that the time for filing petition for writ of certiorari in the above-named cause be, and the same is hereby, extended to and including Jan. 7th, 1956.

Tom C. Clark, Associate Justice of the Supreme Court of the United States.

Dated this 9th day of November, 1955.

[fol. 70] SUPREME COURT OF THE UNITED STATES

[Title omitted]

ORDER ALLOWING CERTIORARI—Filed February 27, 1956

The petition herein for a writ of certiorari to the United States Court of Appeals for the Eighth Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

No. ~~610~~ 75

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

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Statutes and Regulations

IN THE
SUPREME COURT OF THE UNITED STATES

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No. ....

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

VS.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in the above entitled proceeding on August 11, 1955.

CITATIONS TO OPINIONS BELOW.

The findings of fact and opinion of the Tax Court of the United States (R. 16-24) is reported unofficially in

13 T. C. M. 458. The opinion of the Circuit Court of Appeals printed in Appendix A hereto, *infra*, p. 9, is reported in 224 F. 2d 947 (C. C. A. 8th).

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on August 11, 1955, Appendix A, p. 19, *infra*. The time for filing Petition for Writ of Certiorari was, on November 9, 1955, extended to and including January 7, 1956. Appendix A, p. 20, *infra*. The jurisdiction of this Court is invoked under *28 U. S. C., Section 1254*.

QUESTION PRESENTED.

A corporation borrowed from a bank, and the taxpayer petitioner co-signed the corporate notes as guarantor. The corporation's business was not successful, and its assets were sold. The proceeds of the sale did not cover its indebtedness, and the taxpayer petitioner had to pay the corporation's notes to the bank. Were the taxpayer petitioner's losses non-business debts under Section 23(k)(4) of the United States Internal Revenue Code of 1939, or did such losses result from a transaction entered into for profit within the meaning of Section 23(e)(2) of the United States Internal Revenue Code of 1939?

STATUTES.

The pertinent provisions of the United States Internal Revenue Code of 1939, adopted by Act of February 10, 1939, Ch. 2, 53 Stat. 1-504 and Regulations applicable thereto are set forth in Appendix "B."

STATEMENT.

Petitioners duly filed their petition for a redetermination of their personal income tax liability with the Tax Court of the United States for the calendar years 1947 and 1948. The Tax Court of the United States had jurisdiction over the proceeding in the first instance, in accordance with Section 272(a) of the United States Internal Revenue Code of 1939. The Tax Court of the United States rendered its findings of fact and opinion on May 12, 1954 (R. 16-24), and entered its decision on May 13, 1954 (R. 24), on the basis of the pleadings, oral testimony, arguments and briefs.

It was determined by the Tax Court of the United States that the payment by petitioner Max Putnam of the sum of $9,005.21 as guarantor on notes of Whitehouse Publishing Company, a corporation, which corporation was fully liquidated at the time of such payment, gave rise to a non-business bad debt deduction under Section 23(k)(4) of the United States Internal Revenue Code of 1939. The Tax Court of the United States did not consider petitioners' argument that the performance by petitioner Max Putnam of his obligations as guarantor for Whitehouse Publishing Company gave rise to a loss resulting from a transaction entered into for profit within the meaning of Section 23(e)(2) of the United States Revenue Code of 1939 (R. 24).

With the finding of the Tax Court that the loss resulted in a non-business bad debt deduction under Section 23(k)(4), the court below agreed. However, the Circuit Court did consider petitioners' alternative argument that the losses resulting from the performance of the guaranty were deductible under Section 23(e)(2). The Circuit

Court rejected petitioners' arguments in that regard and concluded that the great weight of authority favored the treatment of the loss as a non-business bad debt deductible as a short-term capital loss under Section 23(k)(4), and that such loss did not come under the provisions of Section 23(e)(2).

In so holding, the court below refused to follow the decisions handed down by three other Circuits in which contrary decisions involving the same basic factual circumstances were reached.

Pollak v. *Commissioner*, 209 F. 2d 57 (C. C. A. 3d).
Edwards v. *Allen*, 216 F. 2d 794 (C. C. A. 5th).
Cudlip v. *Commissioner*, 220 F. 2d 565 (C. C. A. 6th).

REASONS FOR GRANTING THE WRIT.

1. The action of the court below in holding that a loss sustained by a guarantor of a corporate obligation at a time when the corporation has been fully liquidated, gives rise to a non-business bad debt deduction under Section 23(k)(4) of the United States Internal Revenue Code of 1939, rather than a loss from a transaction entered into for profit under Section 23(e)(2), creates a direct conflict between the Eighth Circuit and the Third, Fifth and Sixth Circuits.

Pollak v. *Commissioner, supra.*
Edwards v. *Allen, supra.*
Cudlip v. *Commissioner, supra.*

2. The action of the court below in holding that a bad debt can arise against a corporation which had become insolvent and which had been fully liquidated is also contrary to the principles enunciated by the Second Circuit in *Fox* v. *Commissioner*, 190 F. 2d 101. In the Fox case the court

realistically points out that a debt can arise only where there is an expectation of recovery. No debt arises simply from the making of a guaranty, but can only arise when the guaranty is performed. If at the time of performance of the guaranty, circumstances make recovery an impossibility, it is likewise impossible for a debt to arise or to come into existence. A bad debt deduction may arise only where a debt exists. In the Fox case the court said:

> "It is utterly unrealistic to consider the payment as one made in any expectation of recovery over or of any legal claim for collection. Actually it was merely the fulfillment of her contractual obligation of the earlier date. The bad debt provision thus had no direct application; only by straining the statutory language can we erect here a disembodied debt against an insolvent and long dead debtor."

3. The decision of the Circuit Court sustaining the action of the Tax Court of the United States in this proceeding is believed to be the *first* case of its kind to reach the United States Supreme Court. In view of the direct conflict between the decision of the court below and the Circuit Courts for the Third, Fifth, and Sixth Circuits, and in view of the completely unrealistic holding of the court below that a debt can arise against an insolvent and fully liquidated corporation where there is no hope whatsoever of recovery, which holding is in conflict with the Second Circuit in *Fox* v. *Commissioner, supra,* it is in the public interest that the Supreme Court of the United States review the decision of the Eighth Circuit herein.

4. The court below in holding that the weight of authority is contra to the decisions in *Pollak* v. *Commissioner, supra, Edwards* v. *Allen, supra,* and *Cudlip* v. *Commissioner, supra,* makes reference to the following cases:

Burnet v. *Clark,* 287 U. S. 410.

Commissioner v. *Smith*, 203 F. 2d 610 (C. C. A. 2d).
W. F. Young, Inc., v. *Commissioner*, 120 F. 2d 159 (C. C. A. 1st).

The cases relied upon by the court below are not opposed to the Circuit Court decisions cited and relied upon by the petitioner herein. The *Burnet* case arose in connection with a claimed net operating loss carry-forward which the taxpayer sought to deduct in subsequent years. It is to be noted that the taxpayer therein was permitted to deduct the losses in the year in which they were suffered, but under the statutes permitting the carry-forward of a net operating loss, the taxpayer failed to establish that the losses were the result of the operation of a trade or business regularly carried on by the taxpayer. The statute with which the court was there concerned was not the same or similar to Section 23(e) (2) of the United States Internal Revenue Code of 1939. As a consequence, the case of *Burnet* v. *Clark*, *supra*, was not in point with reference to the issues before the court below.

The cases of *Commissioner* v. *Smith* and *W. F. Young, Inc.*, v. *Commissioner*, *supra*, involved loans and advances made by a taxpayer petitioner to a corporation in which the petitioner was a stockholder. There was no question in either of those cases as to the existence of a debt; and the only question there involved was whether or not the debt was of a business or non-business nature.

As a consequence, it is apparent that the cases cited by the court below as representing the great weight of authority were not even remotely in point on the issue here involved.

CONCLUSION.

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

....,

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Counsel for Petitioners.

APPENDIX A.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT.

Decided August 11, 1955.

Docket No. 15,190.

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

VS.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

Petition to Review Decision of the Tax Court of the United States.

Richard E. Williams, for petitioners, Dudley J. Godfrey, Jr., Special Assistant to the Attorney General (H. Brian Holland, Assistant Attorney General, and Ellis N. Slack and Joseph F. Goetten, Special Assistants to the Attorney General, were on the brief), for respondent.

Before Gardner, Chief Judge, and Woodrough and Thomas, Circuit Judges.

Thomas, Circuit Judge: Petitioners, Max Putnam and Elizabeth Putnam, seek a review and reversal of a decision of the Tax Court of the United States (13 T. C. M. 458; T. C. Memo. 1954-37) entered on May 13, 1954, sustaining the determination of the Commissioner of Internal Revenue that there was a deficiency in their income tax return for the year 1947 in the sum of $1,411.16 and for the year 1948 in the sum of $2,121.56.

Petitioners contend here, as they did in the Tax Court, that they were entitled in their 1947 return to a deduction of $8,492.32 as a business bad debt deduction under Sec. 23(k)(1) of the Internal Revenue Code of 1939, and in their 1948 return to a deduction of $9,005.21 under Sec. 23(k)(1), *supra*, or as a loss resulting from a transaction entered into for profit within the meaning of Sec. 23(e)-(2) of the Internal Revenue Code of 1939. Instead the Commissioner determined that the losses sustained in 1947 and 1948 constituted non-business bad debts deductible only as short-term capital losses under Sec. 23(k)(4) of the Internal Revenue Code. The Tax Court sustained the determination of the Internal Revenue Commissioner, and thereafter petition to review such decision was filed.

The alleged errors of the Tax Court relied on by the petitioners are that:

The court erred in holding that the debts owing petitioner, Max Putnam, which became worthless in 1947 and 1948 were non-business debts, in that (a) the losses resulting from the worthlessness of such debts were proximate to and incurred in petitioner's business as a practicing attorney; (b) that the worthlessness of such debts (if debts existed) was deductible as a loss under said Sec. 23(k)(1); or (c) that the loss suffered by petitioner as a guarantor on the notes he was compelled to pay resulted from a transaction entered into for profit within the meaning of Sec. 23(e)(2) of said Internal Revenue Code.

(Facts.)

Petitioners, husband and wife, reside in Des Moines, Iowa. They filed joint income tax returns for the years 1947 and 1948. Since 1931 the petitioner, Max Putnam, has been continuously engaged in the practice of law in Des Moines.

The transaction with which we are concerned resulted from the organization of the Whitehouse Publishing Company. In 1944 Putnam became legal counsel for Local 441 of the Railway Workers Union at Des Moines, continuing in that capacity until 1949. Through one Gilbert, business agent of the Union, he met Meredith Case, editor of the Des Moines Federationist, a weekly labor newspaper, which had the endorsement of the local trades and labor assembly, but which was controlled by Leo Quinn, business manager of the Local Teamsters' Union, A.F.L., and other Union interests.

On August 17, 1946, the Whitehouse Publishing Company was incorporated for the purpose of carrying on a general printing and publishing business. Its capital stock consisted of 15 shares of the par value of $100 each, five shares of which were issued to petitioner, and five shares each to Case and Quinn. While Case and Quinn had a reputation for honesty and integrity, they had no means or cash available to put into the corporation. For himself and on behalf of Case and Quinn, Putnam transferred a lot valued at $1,000 to the corporation, paid $5,500 for the construction of a building thereon; and made a cash contribution ~~of $1,500 as working capital~~. He also guaranteed the payment for supplies purchased by Whitehouse and of its employees' salaries.

Case and Quinn agreed to and did execute to petitioner their promissory notes, each equal to one-third of the cost of the real estate and the building, and of the cash which Putnam had put into the company. In November, 1946, these notes aggregated the sum of $8,492.32 and were secured by pledge of the Whitehouse Publishing Company stock owned by Case and Quinn. Their debts to the petitioner became worthless in 1947. In February, 1947, Case's notes to petitioner were cancelled and his shares of stock

in Whitehouse were assigned to petitioner who was to receive promissory notes in like amount from Whitehouse. In July, 1947, Quinn's notes to petitioner were cancelled and his shares of stock in Whitehouse were assigned to petitioner, who was to receive notes for the same amount from Whitehouse. Nothing in the record indicates whether petitioner ever received such notes from Whitehouse.

On August 20, 1946, petitioner and Whitehouse Publishing Company borrowed $12,075 from the Central National Bank and Trust Company of Des Moines for the use of the corporation and signed a promissory note therefor as co-makers.

Petitioner, on November 13, 1946, borrowed the sum of $3,500 which he made available to the Whitehouse Publishing Company.

In March, 1947, Whitehouse and petitioner borrowed from the bank the further sum of $5,000 and signed a promissory note therefor as co-makers.

This publishing enterprise was not successful. By July, 1947, the publishing company's only assets were its building and equipment. It was receiving some income from payments on orders for a publication it had printed, but at the same time its indebtedness amounted to $13,500. Its building was sold for $7,000 and it ceased to do business. From the $7,000 thus received $5,000 was used toward paying off the promissory note of August 20, 1946, and $2,000 was turned over to the petitioner for the advances he had made.

In December, 1948, petitioner paid to the bank the balance of $3,500 due on the note of August 20, 1946, and the $5,000 note of March, 1947, which notes with interest totaled the sum of $9,005.21.

(Code Provisions.)

The pertinent statute in determining the issues here is Sec. 23 of the Internal Revenue Code of 1939 (26 U. S. C., 1952 Ed., Sec. 23), which reads as follows:

"Sec. 23. Deductions from Gross income.

* * * * * * *

"(e) Losses by Individuals. In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

"(1) if incurred in trade or business; or

"(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

* * * * * * *

"(k) Bad Debts.—

"(1) (as amended by Section 124(a) of the Revenue Act of 1942, and Section 113 of the Revenue Act of 1943) General rule.—Debts which become worthless within the taxable year; * * * This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined ~~in paragraph~~ (4) of this subsection.

* * * * * * *

"(4) (As added by Section 124(a) of the Revenue Act of 1942, *supra*) *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term 'non-business debt' means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

In this publishing venture which turned out so unfortunately for the petitioner, Max Putnam, there is no question but that he sustained the losses for which he claims deductions in the joint income tax returns of himself and his wife for the years 1947 and 1948.

However, the questions we must answer are whether the losses which he suffered were proximate to and incurred in his business as a practicing attorney and whether the balance of the debt he was compelled to pay to the bank was connected with a transaction entered into for profit, or a "non-business" debt.

Petitioner does not contend that he was in the business of investing in, organizing, and financing business enterprises as such. He was a practicing attorney. He contends that all of his activities connected with various enterprises, including the advances and loans to Case and Quinn, were part of his activities as a lawyer directed toward the betterment of attorney-client relationships and for increasing his clientele.

(Cases Cited by Taxpayer.)

To show that the loss of $8,492.32 resulting from the debts owing him by Case and Quinn were proximate to and incurred in his business as a practicing attorney he calls attention to two cases from the Tax Court: *Fisher Brown et al.* v. *Commissioner,* 9 T. C. M. 1045 (1054); and *Hogan* v. *Commissioner,* 3 T. C. 691; also cited is the case of *Maloney, Collector,* v. *Spencer,* 9 Cir., 172 F. 2d 638. A reading of these cases does not convince us that the situations in them are analogous to the situation here, as petitioner contends. The loans to Case and Quinn were not proximate to or incurred by him as an attorney; they were not essential to his law practice. *Burnet* v. *Clark,* 287 U. S. 410; *Omaha National Bank* v. *Commissioner,* 8

Cir., 183 F. 2d 899. His loss from the debts owing him by Case and Quinn was not "attributable to the operation of a trade or business regularly carried on by the taxpayer." *Dalton* v. *Bowers*, 287 U. S. 404, 409.

In the cases cited, *supra*, by the petitioner the taxpayers advanced money to or guaranteed loans for business which were closely associated with their various business enterprises. For instance, in the *Fisher Brown* case the taxpayer was a wholesale distributor of furniture. He advanced and loaned money to his son-in-law, a manufacturer of furniture. The business failed and taxpayer's loss was treated as a business bad debt under Sec. 23(k)(1) of the Internal Revenue Code, the Tax Court saying: "We conclude that the petitioner made the advances to Marín as loans for purposes connected with his business as a distributor of furniture * * *" We fail to see the analogy and hold this contention to be without merit.

The facts here bear a striking similarity to the facts in the case of *Omaha National Bank* v. *Commissioner*, 8 Cir., 183 F. 2d 899. There L. F. Crofoot, deceased before the case reached the appellate court, and for whose estate the bank was special administrator, was a practicing attorney in Omaha, Nebraska, during all the period involved. In order to protect loans he had made to one Rosso, a restaurant and tavern operator, the business was incorporated with a capital stock of $40,000, and finally the taxpayer owned 333 shares of the stock for which he had paid $33,450. From its inception the business did not prosper, and finally the corporate assets, including the building, were sold for $15,000. After the distribution of the assets there was still owing the taxpayer on money loaned to the corporation the sum of $10,407.90, which he claimed as a business bad debt. The Tax Court held that his losses were

not suffered in his "trade or business"; that the petitioner was not engaged in the restaurant business, which was conducted by a corporation; and that it was not his individual business. One of the principal cases relied on by the Tax Court was that of *Burnet* v. *Clark*, 287 U. S. 410, wherein it was said: "The unfortunate endorsements were not part of his ordinary business but were occasional transactions intended to preserve the value of his investment in capital shares." This court affirmed, holding that the loss suffered by the taxpayer was not incurred "in his trade or business." See, also, *Nicholson* v. *Commissioner*, 10 Cir., 218 F. 2d 840 (240); *Chicago Title & Trust Co.* v. *United States*, 7 Cir., 209 F. 2d 773; *Commissioner* v. *Smith*, 2 Cir., 203 F. 2d 310, cert. den. 346 U. S. 816. The loans advanced to Case and Quinn were not business bad debts allowable as deductions under Sec. 23(k)(1), but the loss of the $8,292.32 which taxpayer sustained in 1947 constituted a non-business bad debt deductible only as a short-term capital loss under Sec. 23(k)(4) of the Internal Revenue Code of 1939.

Finally we consider whether the losses of petitioner resulted from a transaction entered into for profit within the meaning of Sec. 23(e)(2), "though not connected with the trade or business."

We have already considered that the loans made to Case and Quinn resulting in the loss of $8,492.32 were non-business bad debts deductible as short-term capital losses. These loans cannot be considered as transactions entered into for profit within the meaning of Sec. 23(e)(2). Only if the publishing venture had proved successful would there have been any chance to be reimbursed by Case and Quinn. At no time had they anything of value from which reimbursement could be had. Petitioner admits they were "judgment-proof."

(Notes Signed As Co-maker.)

We next consider whether the loss which resulted in 1948 comes under Sec. k (e)(2). In December, 1948, taxpayer was compelled to pay to the bank the sum of $9,005.21. The amount represented the balance of $3,500 due on the $12,075 note of August 20, 1946, and the $5,000 note executed in March, 1947, both of which notes petitioner signed as co-maker with the Whitehouse Publishing Company.

Very little discussion is needed on this point. It is true that in the case of *Cudlip* v. *Commissioner*, 6 Cir., 220 F. 2d 565, that court reversed the decision of the Tax Court. Cudlip was an attorney, and his law practice had to do principally with banks, corporations and business ventures. He became interested in WiRecorder Corporation, and in 1947 with two others he became a guarantor on the corporation's note for $90,000. The corporation was not successful and on November 23, 1949, notified the bank that it was unable to meet its obligation upon the note. Whereupon, in accordance with his guaranty agreement, Cudlip paid the bank on November 25, 1949, $30,000 plus $200 of interest due on the note. The other guarantors likewise paid $30,000 each on the note. The corporation was insolvent; its corporate existence terminated on December 13, 1949; and petitioner Cudlip never recovered anything from the corporation. The Sixth Circuit, reversing the decision of the Tax Court (12 TCM 1290), stated that the loss incurred resulted from a transaction entered into for profit under Sec. 23(e)(2). In its opinion the court said that "Taxation is concerned with realities, and * * * the contentions here advanced by the Commissioner are completely unrealistic," and remanded the case for allowance of the claimed deduction under Sec. 23(e)(2), relying particularly upon *Pollak* v. *Commissioner*, 3 Cir.,

209 F. 2d 57, 58, and *Allen* v. *Edwards*, D. C. Ga., 114 Fed. Supp. 672, 674 (affirmed by the Fifth Circuit in *Edwards* v. *Allen*, 216 F. 2d 794). In a vigorous dissenting opinion, Judge Stewart stated: "Yet, until the *Pollak* and *Allen* cases, and today's decision in this case, the debt so arising has consistently been considered nonetheless deductible as a bad debt, although it became worthless immediately upon its ripening from a secondary obligation into a debt." Citing Cases.

Considerable diversity of opinion exists among the different circuits as to deductions from gross income under Sec. 23 of the Internal Revenue Code. We find no case in the Supreme Court overruling its decision as to a nonbusiness bad debt loss since the publication of its decision in *Burnet* v. *Clark*, 287 U. S. 410. In spite of the recent opinion of the Sixth Circuit in the *Cudlip* case, *supra*, the great weight of authority is that a transaction such as that of Whitehouse Publishing Company and petitioner with the bank, wherein petitioner was compelled, as co-maker or guarantor, to pay the balance due on the notes to the bank in the sum of $9,005.21, including interest, is a nonbusiness bad debt deductible as a short-term capital loss under Sec. 23(k)(4), and that such loss does not come under the provisions of Sec. 23(e)(2) where deduction is allowable "if incurred in any transaction entered into for profit, although not connected with the trade or business." See and compare *Burnet* v. *Clark*, 287 U. S. 410; *Commissioner* v. *Smith*, 2 Cir., 203 F. 2d 610 (310); *W. F. Young, Inc.*, v. *Commissioner*, 1 Cir., 120 F. 2d 159.

The decision of the Tax Court as to a deficiency in the petitioners' income tax returns for 1947 and 1948 in the sums of $1,411.16 and $2,121.56, respectively, is, therefore, Affirmed.

(JUDGMENT.)

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

SEPTEMBER TERM, 1954.

No. 15,190.

Thursday, August 11, 1955.

MAX PUTNAM AND ELIZABETH PUTNAM, PETITIONERS,

VS.

COMMISSIONER OF INTERNAL REVENUE.

Petition to Review Decision of the Tax Court of the United States.

This cause came on to be heard on the Petition to review a decision of The Tax Court of the United States entered May 13, 1954, determining that there were deficiencies in the income tax returns of the petitioners for the years 1947 and 1948, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the decision of the said Tax Court in this matter be, and the same is hereby, affirmed.

And it is further Ordered by this Court that the petition to review in this matter be, and the same is hereby,

/s/ E. E. Koch,
Clerk.

dismissed.

August 11, 1955.

SUPREME COURT OF THE UNITED STATES.

October Term, 1955.

No. ....

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

VS.

COMMISSIONER OF INTERNAL REVENUE.

Order Extending Time to File Petition for Writ of Certiorari.

Upon Consideration of the application of counsel for petitioners,

It is Ordered that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby extended to and including January 7th, 1956.

/s/ Tom C. Clark,
Associate Justice of the Supreme Court of the United States.

Dated this 9th day of November, 1955.

APPENDIX B.

Internal Revenue Code of 1939.

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

* * * * * * *

(k) *Bad Debts.*—

(4) (As added by Section 124(a) of the Revenue Act of 1942, *supra*) *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(26 U. S. C., 1952 Ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(e)-1. *Losses by Individuals.*—Losses sustained by individual citizens or residents of the

United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23(g) and 117, relating to capital losses, section 23(h), relating to watering losses; section 24(b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possession of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, *bona fide*, and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113(b). For special provisions with respect to war losses, see section 127.

* * * * * * *

Sec. 29.23(k)-6 (As amended by T. D. 5458, 1945-1 Cum. Bull. 45). *Non-Business Bad Debts.*—In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting there-

from shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this subdivision applicable in the case of a loss resulting from a security as defined in section 23(k)(3). A non-business debt is a debt, other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23(k)(3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transactions covered by section 23(e) is "incurred in trade or business" under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purpose of this section.

To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the

calendar year basis, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1943. A's loss is controlled by the non-business debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to his son C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is

controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1942, A, in liquidating the business, attempts to collect B's claim but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

* * * * * * * *

IN THE

Supreme Court of the United States

OCTOBER TERM 1956

MAX PUTNAM AND ELIZABETH PUTNAM
Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE
Respondent

No. 25

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONERS

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court of the United States (R. 14-21) is reported unofficially in 13 *T.C.M.* 458. The opinion of the United States Court of Appeals for the Eighth Circuit is reported in 224 *F. 2d* 947. (C.C.A. 8th) (R. 27-34)

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit was entered on August 11, 1955 (R. 35). Petition for Writ of Certiorari was filed January 5, 1956, and was granted February 27, 1956. The jurisdiction of this court is invoked under 28 *U.S.C. Sec.* 1254.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the United States Internal Revenue Code of 1939, adopted by the act of February 10, 1939, Ch. 2, 53 Stat. 1-504 and Regulations applicable thereto, are set forth in the appendix infra. pp. 21-25.

QUESTION PRESENTED

The corporation borrowed from a bank, and the taxpayer petitioner co-signed the corporate notes as guarantor. The corporation's business was not successful, and its assets were sold. The proceeds of the sale did not cover its indebtedness, and the taxpayer petitioner had to pay the corporation's notes to the bank. Were the taxpayer petitioner's losses non-business debts under Section 23(k)(4) of the United States Internal Revenue Code of 1939, or did such losses result from a transaction entered into for profit within the meaning of Section 23(e)(2) of the United States Internal Revenue Code of 1939?

STATEMENT

The facts as found by the Tax Court and by the Court of Appeals are substantially as follows:

The petitioners are husband and wife, and reside at Des Moines, Iowa, where Max Putnam is, and has been, engaged in the general practice of law since 1931 (R. 14).

On August 17, 1946, the petitioner, Max Putnam, and two other parties named Case and Quinn brought about the incorporation of Whitehouse Publishing Company for the purpose of carrying on a general printing and publishing business (R. 15). Putnam furnished all of the consideration for the issuance of stock, which was issued in equal amounts

to Putnam, Case and Quinn (R. 15, 16). Case and Quinn agreed to, and did, execute to Putnam their individual promiss y notes, each equal to one-third of the consideration furnished by Putnam to the corporation for its stock, which notes were secured by a pledge by Case and Quinn of the stock issued to them in Whitehouse Publishing Company (R. 16, 29). The debts of Case and Quinn to the petitioner became worthless in 1947 (R. 19, 29).

In February 1947 Case's notes to petitioner were cancelled and his shares of stock in Whitehouse were assigned to petitioner (R. 16). In July 1947 Quinn's notes to petitioner were cancelled and his shares of stock in Whitehouse were assigned to petitioner (R. 16).

On August 20, 1946, petitioner and Whitehouse Publishing Company borrowed $12,075.00 from Central National Bank and Trust Company of Des Moines for the use of the corporation, and they signed a promissory note therefor as co-makers (R. 16). Whitehouse Publishing Company was the primary obligor on the notes, and Petitioner Putnam was in fact acting only as guarantor (R. 19).

In March 1947 the petitioner and Whitehouse borrowed an additional $5,000.00 from Central National Bank, and again signed a promissory note as co-makers (R. 16), although Whitehouse was the primary obligor and Putnam guarantor thereof (R. 19).

By the middle of 1947 is was evident that the publishing venture was unsucessful (R. 16). In July 1947 Whitehouse sold its assets and ceased to do business (R. 17). From the proceeds of the sale of corporate assets, the first obligation to the bank in the amount of $12,075.00 was reduced to the sum of $3,500.00, but no payment was made on the $5,000.00 obligation to the bank (R. 17). As a consequence, after all corporate assets had been disposed of, an indebtedness to the bank in the amount of $8,500.00 remained, together with interest thereon (R. 17).

In December 1948 the petitioner Putnam paid the balance of the indebtedness to the bank, consisting of principal of $8,500.00 and interest of $505.21 (R. 17).

On petitioners' 1948 income tax return, they claimed a business bad debt deduction of $9,005.21, consisting of the principal and interest paid by petitioner to the bank (R. 17). The Commissioner of Internal Revenue proposed to treat said amount as a non-business bad debt, and to impose the short-term capital loss limitations thereon. The Commissioner's contention has been upheld, both in the Tax Court of the United States and in the United States Court of Appeals for the Eighth Circuit.

SUMMARY OF ARGUMENT

The Commissioner of Internal Revenue recognizes that petitioner Putnam suffered a loss as a consequence of the performance of his guarantee of the corporate obligations to the bank. He urges that the performance by Putnam of his obligations under the guaranty gave rise to a debt. He concludes that, since the "debt" was worthless when it came into existence, it became worthless during the year in which the guaranty was performed, and that the loss resulting therefrom is deductible as a bad debt. He categorizes the "debt" as non-business, and seeks to impose the short-term capital loss limitations on the deductibility of the loss.

The Commissioner's reasoning fails to recognize that Section 23(k) of the 1939 Internal Revenue Code, which section was enacted in 1942, was intended as a safe-guard against the deductibility of losses on family and friendship loans which were actually gifts. He fails to recognize that Section 23(k) was not intended to apply to obligations to reimburse which arose by operation of law, and was in-

tended to apply only to the loss suffered by the actual creditor. Section 23(k) should apply only to transactions recognized as creating a debt at their inception.

Section 23(k) is applicable only where a debt has come into existence. The guaranty executed by Putnam created no debt. It merely entitled Putnam to subrogation to the bank's claim against Whitehouse, a claim long since worthless. The performance by Putnam of his obligations under the guaranty could create a debt, under his right to reimbursement by Whitehouse, only if there were a reasonable hope and expectation of recovery at the time of such performance. Since the primary obligor, Whitehouse Publishing Company, a corporation, had been completely liquidated at the time of petitioner's performance of the guaranty, there was no hope or expectation of recovery by Putnam from the corporation. Hence, there was no debt so as to bring the loss under Section 23(k). Furthermore, for a loss resulting from a bad debt to fall within the purview of Section 23(k), the debt must have *become* worthless in the year of loss. The alleged "debt" could not have *become* worthless during the year, since it was worthless at the inception. Therefore, the loss suffered by petitioner Putnam is not deductible under Section 23(k), but is deductible under Section 23(c)(2) as a loss resulting from a transaction entered into for profit.

ARGUMENT

THE PETITIONER'S LOSS RESULTING FROM THE PERFORMANCE BY HIM OF HIS GUARANTEE OF THE CORPORATE OBLIGATION TO THE BANK WAS NOT THE CONSEQUENCE OF A DEBT WHICH BECAME WORTHLESS WITHIN THE TAXABLE YEAR. PETITIONER'S LOSS WAS A LOSS SUSTAINED DURING THE TAXABLE YEAR INCURRED IN A TRANSACTION ENTERED INTO FOR PROFIT.

I

Section 23(k) of the Internal Revenue Code of 1939 applies only where the taxpayer has extended credit to the debtor, and does not apply to obligations arising by operation of law.

Section 23(k) of the Internal Revenue Code of 1939 was enacted in 1942, and was intended as a safeguard against the deductibility of losses on family and friendship loans which were actually gifts and were not the result of the operation of a trade or business or the result of a transaction entered into for profit. It was intended to prevent the easy deductibility of bad debts under the prior law, which had led to abuses in the form of making loans, without any reasonable expectation of repayment, to friends or related persons. The 1942 enactment attempted to solve the problem by dividing loans into business and non-business categories, and by limiting the deductibility of all bad debts in the non-business category.

The Commissioner of Internal Revenue, in his construction of Section 23(k), has gone beyond the intent and purpose of the enactment and has gone well beyond the matter of denying deductions where purported loans were actually

gifts. He has attempted to bring within the purview of Section 23(k)(4) many losses which were not intended to be governed as to deductibility by that section, and has attempted to destroy the full deductibility of losses sustained in truly commercial transactions. To some extent he has been successful in procuring narrow judicial construction in support of his interpretation of the law.

Section 23(k) was obviously not intended to apply generally to obligations to reimburse arising by operation of law. However, the Commissioner has attempted to apply the bad debt provisions to obligations arising by operation of law if the obligations are such that they fall within the non-business category. On the other hand, if the obligation to reimburse arises by operation of law, but is not incurred in trade or business, and is not incurred in a transaction entered into for profit, then the Commissioner contends that such obligation does not result in a debt within the purview of Section 23(k). It would seem that obligations arising by operation of law should all fall within or all fall without the scope of the bad debt provisions. The Commissioner seeks to make the bad debt provisions apply only with reference to those obligations arising by operation of law, which obligations, upon becoming worthless, can be classified as non-business bad debts. If the obligation arising by operation of law is not incurred in trade or business or in a transaction entered into for profit, he contends that the obligation, upon becoming worthless, is not a debt of the type contemplated by Section 23(k).

To illustrate the Commissioner's inconsistency with reference to the treatment of obligations arising by operation of law which have become worthless, compare his position in the instant case, and others similar thereto, with the position successfully taken by him in *Katherine J. Hanes vs. Commissioner of Internal Revenue*, 2 T.C. 213. In the

Hanes case the taxpayer sought to take a deduction for a bad debt, on the ground that she had been defrauded when she purchased bogus oil paintings for her home, a consequence of fraudulent representations made to her by the vendor. She argued that, as a result of the misrepresentation by the seller, she had a cause of action against the seller, which was a debt; that the debt had become worthless, and therefore she should be entitled to a bad debt deduction.

The Tax Court pointed out that Sections 23(e) and 23(k) were mutually exclusive, and that the nature of the item in dispute must determine which is applicable. The court concluded that Section 23(e) was applicable because the transaction resulted in a loss rather than a debt as that word is used in sub-Section (k). Since the loss was not one resulting from a transaction entered into for profit, it was not deductible under Section 23(e).

Thus, in the *Hanes* case the Commissioner successfully contended that the claim against the vendor, resulting as it did by operation of law, did not give rise to a debt within the purview of sub-Section (k).

In the instant case and other similar cases cited and discussed infra, the Commissioner contends that obligations arising by operation of law, as a consequence of transactions entered into for profit, do come within the scope of the bad debt provisions. Not only the inconsistency but the reason therefore is apparent. If the obligation arises by operation of law in a personal transaction, the Commissioner seeks to apply Section 23(e) under which it is not deductible. If the obligation arises by operation of law in a transaction entered into for profit, the Commissioner contends that Section 23(k) is applicable where its deductibility is limited in accordance with the short-term loss provisions. Certainly it is the obligation and responsibilty of the

Commissioner to protect the revenue, but not at the expense of assuming completely inconsistent positions purely for the purpose of arriving at the maximum tax liability.

The foregoing illustration of the Commissioner's inconsistency between the position taken by him in circumstances such as those found in *Hares* and circumstances such as exist in the instant case, demonstrates that federal tax law ought not to be dependent upon technical distinctions in the common law developed to adjust the relations between the parties who are primarily and secondarily liable. The making of such distinctions by the courts has given rise to unnecessary confusion in this field of federal tax law. For example, the Tax Court, and other courts, distinguish between the subrogation debt of a guarantor against a dissolved corporation, as compared with a fully liquidated or bankrupt corporation. See *Greenspon vs. Commissioner*, 8 T. C. 431.

The reasoning of the Circuit Court in the instant case would seem to require a distinction between treatment of the loss of the guarantor and the loss of an indemnitor, and would indicate that a release or waiver of the right of reimbursement by a guarantor, prior to insolvency of the principle debtor and prior to payment by the guarantor, would affect the nature of the loss and the extent of its deductibility.

Inequitable distortions of the type described could and should be avoided, and the existing confusion with reference to the applicability of Section 23(k) could be dispelled if Section 23(k) were limited in its application to those circumstances to which it was originally intended to apply. It is the *creditor* to whom the bad debt provisions should and were intended to apply. Regardless of how the surety may be characterized under local law, the fact remains that he will be called upon to perform only under circumstances

comparable to those under which an insurer must perform. At the time the surety relationship is established, the surety does not anticipate that the debtor will be unable to pay. He does not become a surety because of any reliance upon the prospect that the debtor will reimburse him. His expectation is that the debtor will pay when the debt becomes due. If the debtor does not do so, the surety relationship arrangement results in a loss to the surety because he has over-estimated the financial prospects of the debtor. The surety, being bound by a contract adequately supported by consideration, must pay. The obligation to pay, and the loss resulting therefrom, result from the original guaranty. It does not result from the extension of credit to the debtor.

The matter pending before this court is of such general interest that the court should clarify the scope and range of Section 23(k) so as to avoid the growing confusion with reference to its application, and the application of similar sections of the law under the 1954 Internal Revenue Code.

Even greater confusion with reference to this area of federal tax law may arise under the 1954 Code unless there is a specific clarification of the application of the bad debt provisions. Section 166(f) of the 1954 Code permits a deduction for any payments made by a guarantor or indemnitor of a non-corporate obligation where the funds received by the borrower are used in the trade or business of the borrower. If payment is made at a time when the borrower's obligation to the creditor is worthless, apart from the guaranty or indemnity, the payment will be treated as a debt which became worthless within the taxable year, and the rule as to bad debts, other than non-business bad debts, will apply. The effect of the new provision is to exempt a certain group of guarantors from the rule that a debt, worthless when acquired, cannot afterwards become worthless. This rule was established in *Eckert vs. Burnet*,

283 U. S. 110. This would seem to indicate congressional approval of the application of the *Eckert* rule as to those guarantors not covered by the new provision, and, in effect, require such guarantors to prove that the debt they acquired became worthless within the taxable year, or be denied a bad debt deduction. In other words, by taking this one group of guarantors out of the rule of *Eckert vs. Burnet*, all others remain within it and must take their deduction, if any, under some provision of the Code other than the bad debt provisions. This is no more than an application of the rule of construction *expressio unius est exclusio alterius.* It should be noted also that the new provision has the effect of permitting a deduction as a bad debt of payments made by indemnitors under the same circumstances as payments by guarantors, although an indemnitor has no right of subrogation or reimbursement against the original debtor.

A decision by this court to the effect that Section 23(k) was intended only to apply to those circumstances where the loss results from the extension of credit by the taxpayer to the debtor, would eliminate the wide confusion presently existing, and would bring about a uniform construction by the courts of the provisions of the 1954 Code.

II

Section 23(k) of the Internal Revenue Code of 1939 is not applicable, because there was no debt; and if there was a debt, it did not become worthless during the year.

The execution of the guaranty by Putnam did not create a debt, and, as a consequence, the Commissioner's contention that the bad debt provisions apply, must rest upon the proposition that the performance of the guaranty in 1948 gave rise to a debt in favor of the taxpayer.

Under the law of suretyship this debt may have been the result of Putnam's subrogation to the bank's claim against Whitehouse, or the result of Putnam's right to reimbursement by Whitehouse.

Under Putnam's right to subrogation, he merely became subrogated to the claim which the bank had held against Whitehouse, a claim which became worthless when Whitehouse was liquidated and insolvent. The law is clear that the acquisition of a worthless claim, even for consideration, cannot be the basis for the deduction of a bad debt under Section 23(k).

> *Mountain Wholesale Co., Inc. vs. Commissioner*, 17 T. C. 870;
>
> *Layton vs. Commissioner*, 11 (C. C. H.) T. C. M. 1115;
>
> *Heimbach vs. Commissioner*, 13 (C. C. H.) T. C. M. 210.

Hence, the only basis on which any debt covered by Section 23(k) could exist in Putnam's hands would be under his right of reimbursement resulting from his payment on the guaranty.

It has always been recognized that a debt may come into existence *only* where there is a reasonable hope and expectation of repayment. The right to reimbursement does not arise until the guarantor or surety has made payment to the principal creditor. Certainly no debt could arise in Putnam's favor against Whitehouse Publishing Company which had been fully liquidated, since there was no debtor from whom a reasonable expectation of recovery or repayment existed.

As previously pointed out, the Tax Court has held that the bad debt provisions do not apply with reference to the guaranty of a corporate obligation, if the corporation be dissolved prior to the performance of the guaranty. See:

Greenspon vs. Commissioner, supra;
Hanna, Jr., vs. Commissioner, 10 (C. C. H.) T. C. M. 566, Docket Nos. 25706 and 25707;
J. B. Book, Jr., vs. Commissioner, 8 (C. C. H.) T. C. M. 101, Docket No. 15312.

The Tax Court has also held that the bad debt provisions do not apply with reference to a guaranty where the subrogation debt has been wiped out by reorganization or bankruptcy. See *Ingersoll vs. Commissioner,* 7 T. C. 34.

The Second Circuit, in *Fox vs. Commissioner,* 190 Fed. 2d 101, concluded that the bad debt provision could have no application where the debtor was both insolvent and dead. The court said:

> "Clearly, too, the transaction was not then one involving a bad debt, since she had not even made the payment which alone would give rise to a claim in her favor. Nor could payment ten years later create a debt out of something less than even the proverbial stone. It is utterly unrealistic to consider the payment as one made in any expectation of recovery over or of any legal claim for collection. Actually it was merely the fulfillment of her contractual obligation of the earlier date. The bad debt provision thus had no direct application; only by straining the statutory language can we erect here a disembodied debt against an insolvent and long dead debtor."

Thus the courts have consistently recognized the principal that if, at the time payment is made by a guarantor, the primary debtor is dead or non-existent, or if there is no legal or practical possibility of any recovery over against such debtor, no debt arises, and Section 23(k)(4) is not applicable. If there is no reasonable expectation of recovery, there is no debt. See:

W. F. Young, Inc., vs. Commissioner, 120 F. 2d 159;
American Cigar Co. vs. Commissioner, 66 F. 2d 425, 427 (2nd Circuit) Certiorari denied 290 U. S. 699;
C. B. Hayes, 17 B. T. A. 86;
Layton vs. Commissioner, 11 (C. C. H.) T. C. M. 1115.

Section 23(k)(4), in order to be applicable, requires not only the existence of a debt, but also requires that the debt *become* worthless within the taxable year. Even if it should be held here that a debt, within the meaning of Section (23(k)(4), arose in favor of Putnam against the insolvent and fully liquidated corporation, such debt was worthless when acquired, and could not *become* worthless within the taxable year so as to bring the loss within the purview of Section 23(k)(4).

In *Eckert vs. Burnet*, supra, the petitioner, who was on a cash basis, attempted to deduct as a bad debt the amount of a note given to satisfy his liability as a guarantor of a corporate debt. Mr. Justice Holmes stated: "The debt was worthless when acquired. There was nothing to charge off." The court inferred that the payment might be deductible as a loss when the note was actually paid.

In *Shiman vs. Commissioner*, 60 F. 2d 65 (2nd Circuit), it was held that a payment in discharge of a guaranty was deductible as a debt and need not be considered as a non-deductible gift. However, in *Fox vs. Commissioner*, supra, the holding of *Shiman vs. Commissioner* was overruled, and the court permitted a deduction under Section 23(e)(2) as a loss incurred in a transaction entered into for profit.

Despite some criticism of the decision in *Eckert vs. Burnet, supra,* and attempts to explain it away, the rule of *Eckert vs. Burnet,* supra, has, in most cases except the instant case, been followed and is manifestly correct.

> *Pollak vs. Commisioner*, 209 F. 2d 57 (3rd Circuit);
> *Cudlip vs. Commissioner*, 220 F. 2d 565 (6th Circuit);
> *Edwards vs. Allen*, 216 F. 2d 794 (5th Circuit, affirming 114 F. Supp. 672).

In *Edwards vs. Allen*, supra, it was stated:

> "Indeed, this result, i. e., the requirement of worthlessness is implicit in the statute. Section 23(k) ap-

plies only to 'debts which become worthless within the taxable year.' As the Supreme Court pointed out, a debt which is worthless when acquired by the taxpayer cannot be said to become worthless in his hands."

In the District Court decision which was affirmed by the Fifth Circuit in *Allen vs. Edwards,* still stronger language was used:

> "Counsel * * * argues that the essence of the transaction and the cause of the loss was the failure of the taxpayers to be able to recover over and against the principal debtor on the right of subrogation. The acquisition of such claim against the principal debtor was not the essence or the purpose of the transaction. Taxpayers did not make payment * * * for the purpose of acquiring a worthless claim against the corporation, but made those payments for the purpose of satisfying their liability on their guaranties.
>
> The loss was caused by the necessity of making payment on their liability and not by their failure to obtain salvage."

Even where the guarantor, upon payment of the debt is subrogated to all rights of the creditor, the courts have rejected that theory as a basis for the finding of a debtor-creditor relationship. In *Pollak vs. Commissioner,* supra, the 3rd Circuit said:

> "It is doubtless true * * * that under the doctrine of subrogation the corporation became indebted to (the taxpayer) for the payments made by him on his endorsements and guaranty as and when he made them. But these payments were made under a legal obligation and guaranty which he had entered into previously at a time when he believed that the corporation would prosper and that he would not lose as a result of his action. It is utterly unrealistic to suggest '* * * that Leo L. Pollak when he entered into this transaction' fully intended and expected to be repaid by the then existing solvent corporation."

In *Cudlip vs. Commissioner,* supra, the Sixth Circuit rejected completely the Commissioner's contention that tax-

payers' rights under subrogation gave rise to a debt which became worthless immediately upon coming into existence. The court said:

> "Taxation is concerned with realities; and we concur * * * that the contentions here advanced by the Commissioner are completely unrealistic. The argument that, because of payment on the guaranty, petitioners would have a claim for reimbursement against the insolvent corporation that had no assets, and that, therefore, their loss was a debt which became worthless during the taxable year in which they made the payment, is illusory and untenable."

The theoretical remedies of subrogation and reimbursement should not be the basis for imposing a substantial tax liability where there, as here, they have little foundation in reality.

In a well considered study appearing in University of Pittsburgh Law Review, Volume 17, pages 83-92, this comment is made:

> "A valid distinction exists between a loan and a guaranty, and the tax consequence of each should correspondingly differ. A loan is usually made as an investment and should be treated as any other capital investment; a guaranty is not an asset at all, but is a liability."

The Tax Court and the court below have refused to follow the *Allen, Pollak* and *Cudlip* cases, supra, and they hold that payments made by guarantors of corporate debts are deductible only as non-business debts. The court below makes no reference in its decision to the requirement that a debt, in order to be deductible, must *become* worthless within the taxable year. *Eckert vs. Burnet*, supra, and the rule therein laid down and applied by the other circuits is not even mentioned in the decision below. It would appear from the decision below that there is no requirement that the debt *become* worthless within the taxable year.

Nevertheless, the statute, in Section 23(k)(1), specifically requires that the debt *become* worthless within the taxable year, and this court in *Eckert vs. Burnet*, supra, has recognized that, as an essential requirement to the application of the bad debt provision, worthlessness must occur during the taxable year.

It is necessary to conclude that the Eighth Circuit erred in applying Section 23(k), because neither of the elements essential for the application of that section existed here. There was here no debt because of the absence of reasonable expectation of recovery; and there was no worthlessness occurring within the year, since the subrogation claim was worthless from its inception.

III

Section 23(e)(2) of the Internal Revenue Code of 1939 is applicable because taxpayer's loss was incurred in a transaction entered into for profit.

It is universally recognized that a loss, such as the one in issue here, arising out of a guaranty by a stockholder of a corporate obligation, is a loss incurred in a transaction entered into for profit. See *Pollak vs. Commissioner*, supra; *Cudlip vs. Commissioner*, supra; *Edwards vs. Allen*, supra. It does not appear that the Commissioner contends or has at any time contended that Putnam was prompted, in the making of the guaranty, by any motive other than the hope and expectation of profit through the success of the corporate undertaking.

Neither is there any issue as to the reality of petitioner's loss. The only isue is and has been whether or not the loss is within the purview of Section 23(k) or Section 23(e)(2) of the 1939 Code.

It has long and universally been recognized that Sections 23(e) and 23(k) are mutually exclusive. *Edwards vs. Allen*, supra; *Spring-City Foundry Co. vs. Commissioner*, 292 U.S. 182. A loss resulting from a transaction entered into for profit, other than a loss resulting from a bad debt within the scope of Section 23(k), is deductible in its entirety as a loss incurred in the transaction entered into for profit under Section 23(e)(2). *Pollak vs. Commissioner*, supra; *Edwards vs. Allen*, supra; *Cudlip vs. Commissioner*, supra; *Fox vs. Commissioner*, supra.

In the instant case, the petitioner has suffered a loss which was incurred in a transaction entered into for profit, and since Section 23(k) is not applicable, both because of the absence of a debt and the absence of worthlessness occurring within the year, the residuary terms of Section 23(e) are applicable and taxpayer's loss is deductible in full under that section.

Section 23(e) is a general broad residuary clause which covers those losses, and only those losses, which are not covered by the other more particular subsections of Section 23. Since the loss is recognized to have occurred and was the consequence of a transaction entered into for profit, and since the loss did not result from a debt becoming worthless within the year, then Section 23(e)(2) is applicable and petitioner's loss deductible in full in the year of the performance by petitioner of his guaranty.

IV

The authorities relied upon by the court below are neither pertinent nor controlling on the issue.

The only issue in *Burnet vs. Clark*, 287 U.S. 410 was whether payments made by a guarantor were incurred in his business so as to permit a net loss carryover into the

following year. The deduction claimed here does not depend upon establishing that Putnam incurred his loss in a trade or business. The deduction is claimed by him under Section 23(e)(2) relating to transactions entered into for profit, and not under Section 23(e)(1) relating to losses incurred in trade or business.

In *Edwards vs. Allen*, supra, the Court of Appeals summarily rejected the contention that the loss was not incurred in a transaction for profit, stating:

> "This contention is so clearly at variance with what seems to us to be a common every-day interpretation of simple language that clear and convincing authority in support of this contention would have to be brought forward * * * to support such construction."

In *Pollak vs. Commissioner*, supra, the court said:

> " * * * we all know that a stockholder who thus loans his credit to a corporation does so in hope and expectation that the corporation, with the additional credit thus made available to it will succeed in preserving or adding to the value of his stock * * * "

In the cases cited, and in *Ansley vs. Commissioner*, 217 F. 2d 252 (3rd Circuit), the courts held that the intention of the stockholder in guaranteeing corporate obligations was to increase the value of his stock, and that such intention is that which is required to render a transaction one which was entered into for profit.

In the opinion of the court below, without citation of authority, it is stated:

> "the great weight of authority is that a transaction * * * wherein petitioner was compelled as co-maker or guarantor to pay the balance due on notes * * * is a non-business bad debt deductible as a short-term capital loss."

The court below also relies generally upon *Commissioner*

vs. Smith, 203 F. 2d 610 (2nd Circuit) and *W. F. Young, Inc. vs. Commissioner*, 120 F. 2d 159 (First Circuit).

The issue in *Commissioner vs. Smith* did not deal with the secondary liability of a stockholder guarantor, but only with the question of whether or not debts acknowledged to have become worthless were or were not incurred in a trade or business.

In *Young, Inc. vs. Commissioner*, supra, the First Circuit held that advances made to an insolvent corporation, without expectation of repayment and without hope of later prosperity of the corporation, were gifts and not business bad debts. The court emphasized that there was no reasonable expectation of recovery at the time the advances were made.

It is, therefore, apparent that the decision of the court below was predicated upon a misconstruction of the application of Section 23(k) and Section 23(e), and in reliance upon authorities that are not pertinent to the issue here.

The decision of the Court of Appeals in this case has created a conflict where none should exist, and has given rise to confusion and uncertainty which should be resolved by this court.

CONCLUSION

The decision of the court below should be reversed.

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APPENDIX

INTERNAL REVENUE CODE OF 1939

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * * * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business;

* * * * * * * * * * *

(k) *Bad Debts.*—

(4) (As added by Section 124(a) of the Revenue Act of 1942, supra) Non-business debts.—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(26 *U.S.C.*, 1952., *Sec.* 23)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(e)-1. *Losses by Individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for

profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not, prior to the filing of the return, been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23(g) and 117, relating to capital losses, section 23(h), relating to wagering losses; section 24(b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general, losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, *bona fide*, and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113(b). For special provisions with respect to war losses, see section 127.

* * * * * * * * * * * *

Sec. 29.23(k)-6 (As amended by T.D. 5458, 1945-1 Cum. Bull. 45). *Non-Business Bad Debts.*—In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is

subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this subdivision applicable in the case of a loss resulting from a security as defined in section 23(k)(3). A non-business debt is a debt, other than a debt from the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23(k)(3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transactions covered by section 23(e) is "incurred in trade or business" under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purpose of this section.

To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the calendar year basis, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business, but retains the claim against B. The claim becomes worthless in A's hands in 1943. A's loss is controlled by the non-business debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C, but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to his son, C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss in controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. The loss sustained by A's estate is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1942, A, in liquidating the business, attempts to collect B's claim, but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

No. [illegible] 75

In the Supreme Court of the United States

October Term, 1956

Max Putnam and Elizabeth Putnam,
Petitioners

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

SIMON E. SOBELOFF,
Solicitor General,
Department of Justice, Washington 25, D. C.

In the Supreme Court of the United States

October Term, 1955

No. 610

Max Putnam and Elizabeth Putnam, petitioners

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The question presented is whether the taxpayer's loss resulting from his payment in 1948 as guarantor of a corporation's unpaid debt is deductible in full as an ordinary non-business loss under Section 23 (e) (2) of the Internal Revenue Code of 1939, as taxpayers contend, or as a non-business bad debt deductible only to the limited extent permitted by Section 23 (k) (4) as a short-term capital loss, as both courts below held.[1]

[1] Taxpayers alternatively contended below that the loss was deductible in full as a business bad debt under Section 23 (k) (1), a contention which has been abandoned in the petition. A separate issue litigated below, as to whether a loss claimed in 1947 was deductible as a business or non-business bad debt, has likewise been abandoned.

We submit that the decision below, affirming that of the Tax Court, is correct for the reasons stated in the opinions below and in the dissenting opinion in *Cudlip* v. *Commissioner*, 220 F. 2d 565 (C. A. 6th), which presented the same question. However, as taxpayer alleges, the decision below is in conflict with those of the courts of appeals in the *Cudlip* case and in *Pollak* v. *Commissioner*, 209 F. 2d 57 (C. A. 3d), reversing the Tax Court, and with *Edwards* v. *Allen*, 216 F. 2d 794 (C. A. 5th), affirming the district court. Accordingly, the Commissioner does not oppose the issuance of a writ of certiorari.

Respectfully submitted,

Simon E. Sobeloff,
Solicitor General.

February 1956.

No. 26

In the Supreme Court of the United States

October Term, 1956

Max Putnam and Elizabeth Putnam, Petitioners

v.

Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE [illegible] CIRCUIT

BRIEF FOR THE RESPONDENT

[illegible],
Solicitor General,
[illegible],
Assistant Attorney General,
[illegible],
Assistant to the Solicitor General,
[illegible],
[illegible],
Attorneys,
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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 25

MAX PUTNAM AND ELIZABETH PUTNAM, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 14-21) are not officially reported. The opinion of the Court of Appeals (R. 27-34) is reported at 224 F. 2d 947.

JURISDICTION

The judgment of the Court of Appeals was entered on August 11, 1955. (R. 35.) By order of Mr. Justice Clark, dated November 9, 1955, the time for filing a petition for a writ of certiorari was extended to and including January 7, 1956. The petition for a writ of certiorari, filed on January 5, 1956, was granted on February 27, 1956. (R. 36.) 350 U. S. 964. The

jurisdiction of this Court rests upon 28 U. S. C., Section 1254.

QUESTION PRESENTED

Taxpayer, the controlling stockholder of a corporation, guaranteed payment of promissory notes which the corporation executed in obtaining bank loans. The corporation having become insolvent, taxpayer as guarantor was required to pay the bank, and the corporation was unable to repay him.

The question presented is whether, as taxpayer contends, the amount paid by the taxpayer to the bank was a nonbusiness loss (not involving a bad debt) deductible in full under Section 23 (e) (2) of the Internal Revenue Code of 1939; or whether, as both courts below held, upon his payment as guarantor the taxpayer by subrogation acquired a debt, the loss resulting from the worthlessness of which is deductible only as a capital loss under Section 23 (k) (4).

STATUTES AND REGULATIONS INVOLVED

Pertinent provisions of Sections 23 (e), (g), (k) and 117 (d) of the Internal Revenue Code of 1939, and of Sections 29.23 (e)-1, 29.23 (g)-1 and 29.23 (k)-6 of Treasury Regulations 111 appear in the Appendix, *infra*, pp. 31-36.

STATEMENT [1]

The taxpayers, Max and Elizabeth Putnam, are husband and wife who filed a joint income tax return

[1] Only the facts relating to the single issue presented by the petition for certiorari are summarized. See footnote 2, p. 10, *infra*.

for the taxable year 1948. Max Putnam, hereinafter called taxpayer, is a lawyer who since 1931 has been continuously engaged in the general practice of law in Des Moines.

In 1946 taxpayer, with Meredith Case and Leo Quinn, formed a corporation, the Whitehouse Publishing Company, for the purpose of carrying on a general printing and publishing business. (R. 14–15.) The authorized capital stock of the corporation consisted of 15 shares having a par value of $100 a share. Each of the organizers—taxpayer, Case, and Quinn—received 5 shares of the stock. The corporation's capital was contributed by taxpayer on behalf of himself and the other two organizers, who gave him their notes for his contributions on their behalf and pledged their shares as security. In 1947 Case and Quinn defaulted in payment of their notes, and their shares were transferred to taxpayer. (R. 15–16.)

Taxpayer personally guaranteed payment for all supplies purchased by Whitehouse and payment of the salaries of its employees. In August 1946, taxpayer and Whitehouse borrowed $12,075 from a bank for use of the corporation, and in March 1947 borrowed an additional $5,000 from the bank for use of the corporation. Taxpayer and Whitehouse signed promissory notes for the amounts for that purpose, as comakers. In November 1946, taxpayer borrowed $3,500 and made it available to the corporation. (R. 16.)

By the middle of 1947, it was evident that the publishing venture was unsuccessful. In July 1947,

Whitehouse was receiving some income from payments on purchase orders for a publication it had printed, but its only substantial assets were in its building and equipment. At the same time, it had an indebtedness of $13,500. During that month, Whitehouse ceased doing business and sold its building for $7,000. Of this amount, $5,000 was applied to the unpaid balance of the promissory note of August, 1946, and $2,000 went to taxpayer to pay him for his advances to the corporation. In December 1948, taxpayer paid to the bank the remaining $3,500 due on the promissory note of August, 1946, and the $5,000 due on the promissory note of March 1947. (R. 16–17.)

In ~~his 1948~~ income tax return, filed jointly with his wife, taxpayer claimed a business bad debt deduction in the amount of $9,005.21, which consisted of the $8,500 paid to the bank on the promissory notes executed by taxpayer and the corporation as co-makers, together with interest on those notes. The Commissioner of Internal Revenue determined, however, that the amount due the taxpayer from the corporation by reason of his payments of the notes represented nonbusiness bad debts, and that therefore the taxpayer's losses were deductible only as short-term capital losses under Section 23 (k) (4) of the Internal Revenue Code of 1939. (R. 9, 17.)

Taxpayer filed a petition for redetermination in the Tax Court, contending that he had really acted only as guarantor and not as co-maker of the notes, and that his payments on those notes resulted in business bad debts deductible in full under Section 23 (k) (1) of

the Internal Revenue Code of 1939. In the alternative, taxpayer contended, *inter alia,* that, if his payments as guarantor did not result in business bad debts, the amount of such payments was deductible in full under Section 23 (e) (2) as a loss incurred in a transaction entered into for profit although not connected with a trade or business. (R. 17–18.)

Although accepting the taxpayer's contention, and finding as a fact, that his payments to the bank were made as guarantor, the Tax Court concluded that the payments resulted in nonbusiness bad debts and that therefore the taxpayer's losses were deductible only as short-term capital losses under Section 23 (k) (4). Accordingly, decision was entered in favor of the Commissioner. The Court of Appeals unanimously affirmed. (R. 19–21, 35.)

SUMMARY OF ARGUMENT

Section 23 (e) (2) of the Internal Revenue Code of 1939 authorizes the deduction in full of an individual's nonbusiness losses, if incurred in a transaction entered into for profit. However, Section 23 (k) (4), added to the Code in 1942, removes from the operation of that section a particular class of nonbusiness losses—nonbusiness bad debt losses—and requires that they be treated as capital losses. Consequently, in order for a nonbusiness loss to qualify for deduction in full, it is not enough for the taxpayer to bring himself within the general provisions of Section 23 (e) (2); he must also show that the loss falls outside the spe-

cial capital loss limitation provisions of Section 23 (k) (4)—*i. e.*, that it was not a bad debt loss. By according capital loss treatment to nonbusiness bad debt losses, Section 23 (k) (4) places such losses on a tax parity with similar nonbusiness losses resulting from the worthlessness of investments evidenced by debt or stock securities. Section 23 (g) (2) and (3), and (k) (2) and (3).

The court below properly approved the Commissioner's and the Tax Court's determination that the loss here in question was deductible as a nonbusiness bad debt loss under the special provisions of Section 23 (k) (4), and consequently as a capital loss, not as an ordinary loss under the general provisions of Section 23 (e) (2). The loss resulted from taxpayer's payment as guarantor of a bank loan made to a corporation of which he was organizer and dominant stockholder, and from the corporation's inability to repay him. That the loss was of a nonbusiness character is no longer in issue. That it constituted a bad debt loss within the purview of Section 23 (k) (4) is apparent from (1) the nature of a guarantor's loss, (2) the administrative and judicial treatment of guarantors' losses under the statutory provisions preceding those here involved, and (3) the subsequent legislation with respect to both bad debt losses generally and guarantors' bad debt losses in particular.

It is well settled both generally and under Iowa law that a guarantor upon being required to make payment under his guaranty contract acquires the rights of the creditor by subrogation. The law implies a promise on the part of the principal debtor to reim-

burse the guarantor, and the guarantor's payment is treated not as extinguishing the debt but as merely substituting the guarantor for the creditor. While a guarantor by entering into the guaranty contract and making payment thereunder puts himself in a position where he may sustain a loss, it is only if (and to the extent that) the debt which he acquires by subrogation becomes worthless that he actually sustains a loss. Thus, if he is able to recover in full from the principal debtor, he clearly suffers no loss at all. Since the existence and extent of the loss is wholly and directly dependent upon the worthlessness of the debt owing by the principal debtor, the loss if it occurs is necessarily attributable to the worthlessness of that debt and must therefore be considered a bad debt loss. And since the corporation whose debt taxpayer guaranteed was still in existence, although insolvent, when he made the guaranty payment, the courts below correctly held that upon such payment taxpayer acquired a debt by subrogation, the loss from the worthlessness of which must be considered a capital loss under Section 23 (k) (4).

Both the administrative and the judicial construction of the bad debt provisions of earlier revenue laws recognized that those provisions covered guarantors' losses. With this long-standing construction in the background Congress repeatedly reenacted those provisions without substantial change and without expressing any disagreement with such construction. Under familiar principles, Congress is presumed to have accepted this construction as a correct interpretation of the statute; at all events, there is

no indication that Congress meant to depart from such construction when it enacted the bad debt provisions applicable here. Accordingly, those provisions should be construed to include an individual's non-business losses as guarantor. Congress has also adhered to its consistent treatment of guarantors' losses as bad debt losses in subsequent legislation dealing specifically with certain losses of guarantors of non-corporate obligations.

Furthermore, under taxpayer's construction of the statute, the extent of deductibility of losses from investments in an unsuccessful corporate venture would become dependent entirely on the form rather than the substance of the transaction. Had taxpayer invested the amount involved in exchange for additional stock, his loss upon failure of the corporation unquestionably would have been a capital loss. Section 23 (g) (2) and (3). Had he made the investment by way of a direct loan evidenced by a debt security of the corporation, his loss would likewise have represented a capital loss. Section 23 (k) (2) and (3). And had he made the investment by way of a simple ordinary loan to the corporation, his loss would ~~also~~ have constituted a capital loss. Section 23 (k) (4).

Nothing in the scheme or language of the statute or its history warrants the assumption that Congress intended to accord preferential tax treatment to a loan or an investment loss merely because the transaction takes the form of a guaranty of a loan made by a third party to the corporation. The situation here is essentially the same, legally and practically, as if

taxpayer had borrowed the money from the bank and then lent it to the corporation. In both cases his loss arises from the failure of the corporation to repay him. In both cases the insolvency of the corporation is relevant in determining *when* the loss occurred, not the nature of the loss. In the one case, as in the other, the loss is deductible as a capital loss under Section 23 (k), not as an ordinary loss under Section 23 (e).

ARGUMENT

TAXPAYER'S NONBUSINESS LOSS AS GUARANTOR WAS A BAD DEBT LOSS SUBJECT TO THE LIMITATIONS ON DEDUCTIBILITY CONTAINED IN SECTION 23 (K) (4) OF THE INTERNAL REVENUE CODE OF 1939

A. *Introductory*

The taxpayer, organizer and controlling stockholder of a corporation, financed its activities by making capital contributions, by making direct loans, and by procuring a bank loan which he individually guaranteed. The corporate venture having proved unsuccessful, taxpayer was obliged as guarantor to pay the bank loan, and was unable to obtain repayment from the corporation. The immediate question presented is whether taxpayer's loss resulted from his payment as guarantor of the corporation's unpaid debt and is deductible in full as an ordinary nonbusiness loss under Section 23 (e) (2) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 31), as taxpayer contends, or was a nonbusiness bad debt deductible only as a capital loss under Section 23 (k)

(4) (Appendix, *infra*, p. 33), as both courts below held.[2] Upon the determination of that issue hinges the answer to the broader, underlying question, namely, whether an investor in an unsuccessful corporate venture is entitled to a greater loss deduction for tax purposes if he guarantees loans by third parties to the corporation than if he invests his money directly, e. g., by lending money to the corporation or by buying its stock.

The nonbusiness loss suffered by an individual who has lent money to an unsuccessful corporation is treated as a capital loss.[3] The same treatment is given to the nonbusiness loss of an individual who has provided capital for a corporation in the conventional

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[2] Taxpayer alternatively contended below that the loss in question was deductible in full under Section 23 (k) (1) (Appendix, *infra*, p. 32) as a business bad debt, or under Section 23 (e) (1) (Appendix, *infra*, p. 31) as a business loss other than one resulting from a bad debt. Both courts below found that the loss was of a nonbusiness rather than of a business character, and taxpayer does not challenge their concurrent findings on that issue. The only question raised by his petition for certiorari, and accordingly the only issue here presented (*Helvering* v. *Taylor*, 293 U. S. 507, 511), is whether the loss is deductible under Section 23 (k) (4) as a nonbusiness bad debt loss, or under Section 23 (e) (2) as a nonbusiness loss other than a bad debt loss.

[3] Under Section 23 (k) of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 32-33), the treatment of such a loss as one from the sale or exchange of a capital asset may be required under either paragraph (2) or paragraph (4), depending upon whether or not the loan is evidenced by a security as defined in paragraph (3). Similar provisions are contained in Sections 165 (g) and 166 (d) and (e) of the Internal Revenue Code of 1954 (26 U. S. C. 1952 ed., Supp. II, Secs. 165 and 166).

form of purchasing its stock.[4] The general effect of such treatment is to restrict an individual's nonbusiness loss deductions, since his losses from sales or exchanges of capital assets are deductible only to the extent of his gains from such sales or exchanges, plus his net income or $1,000, whichever is smaller.[5]

Taxpayer contends that the amount which he as guarantor was required to pay the lending bank on the promissory notes of his then wholly owned and insolvent corporation is fully deductible under Section 23 (e) (2) as a nonbusiness loss other than a bad debt loss. The corollary of this contention is that because he made the necessary operating funds available to the corporation indirectly, by lending his credit—*i. e.,* by guaranteeing payment of the bank's loans to the corporation—he is entitled to a greater loss deduction than he would have been entitled to if he had supplied those necessary funds directly. Yet, as a practical matter, taxpayer's loss would have been precisely the same if he had borrowed the money from the bank himself and then lent it to the corporation.

It is the Commissioner's position that the loss incurred by taxpayer as guarantor of loans to his corporation constituted a nonbusiness bad debt loss falling within the purview of Section 23 (k) (4),

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[4] See Section 23 (g) (2) and (3), Internal Revenue Code of 1939 (Appendix, *infra,* pp. 31–32), and Section 165 (g), Internal Revenue Code of 1954, *supra.*

[5] See Section 117 (d), Internal Revenue Code of 1939 (Appendix, *infra,* p. 33), and Section 1211, Internal Revenue Code of 1954 (26 U. S. C. 1952 ed., Supp. II, Sec. 1211).

and consequently is no less subject to the capital loss limitations imposed by that section than losses resulting from direct loans to the corporation. To hold that taxpayer is entitled to a greater loss deduction merely because he lent his credit to the corporation, rather than his money in the first instance, would exalt form over substance and make the tax result depend upon a distinction having no relation to the business realities of such transactions. Nothing in the relevant statutory provisions or their history justifies the conclusion that Congress intended to create any such distinction; and the court below, agreeing with the Tax Court and the well-reasoned dissenting opinion of Judge Stewart in *Cudlip* v. *Commissioner,* 220 F. 2d 565 (C. A. 6th), properly refused to draw one.

B. *Nonbusiness bad debt losses are deductible as capital losses under Section 23 (k) (4), not as ordinary losses under Section 23 (e) (2)*

Section 23 (k) (4) of the Internal Revenue Code of 1939 provides:

> *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and

other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

These provisions were added to the Code by Section 124 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798. Their purpose, as stated in the House Ways and Means Committee Report accompanying the 1942 Revenue Bill, was "to remove existing inequities and to improve the procedure through which bad-debt deductions are taken." H. Rep. No. 2333, 77th Cong., 2d Sess., p. 44 (1942-2 Cum. Bull. 372, 408). Their effect is to subject nonbusiness bad debt losses, which might otherwise qualify for deduction in full under Section 23 (e) (2), to the limitations upon capital losses, and thus place them on a tax parity with similar nonbusiness losses which are accorded capital loss treatment.

Prior to the Revenue Act of 1942, in computing an individual's taxable net income, nonbusiness bad debts received more favorable tax treatment than was generally afforded other nonbusiness losses. Thus, an individual's bad debts, whether business or nonbusiness, were deductible in full.[6] On the other hand, only some of an individual's nonbusiness losses (other than casualty or theft losses) were deductible, *viz.*, those incurred in transactions entered into for profit.[7] Moreover, not all deductible losses were fully deductible. A bad debt loss was deductible only as a

[6] See Section 23 (k) (1), Internal Revenue Code of 1939 (26 U. S. C. 1940 ed., Sec. 23).

[7] See Section 23 (e), Internal Revenue Code of 1939 (Appendix, *infra*, p. 31).

capital loss if the debt was evidenced by a corporate security, and like treatment was accorded worthless stock losses and losses from sales or exchanges of capital assets.[8]

The Revenue Act of 1942, by restricting the deduction of nonbusiness bad debts, brought the tax treatment of those items into closer conformity with that generally afforded an individual's nonbusiness losses.[9] This was accomplished by the amendment of paragraph (1) of Section 23 (k), and the addition of paragraph (4) to that section. Paragraph (1) was amended to provide that it "shall not apply * * * with respect to a nonbusiness debt" as defined in paragraph (4), and the latter paragraph was added to provide that the "loss" resulting from the worthlessness[10] of a nonbusiness debt was to be considered

[8] See paragraphs (1), (2) and (3) of Section 23 (g), and paragraphs (2) and (3) of Section 23 (k), Internal Revenue Code of 1939 (Appendix, *infra*, pp. 31–32).

[9] At the same time, by the addition of a new subsection (a) (2) to Section 23 of the Internal Revenue Code of 1939 by Section 121 (a) of the Revenue Act of 1942, an individual was authorized to deduct nonbusiness expenses paid or incurred in certain profit transactions.

[10] The Revenue Act of 1942, *supra*, also made the test of deductibility, in the case of bad debts and certain worthless securities evidencing indebtedness, similar to that applied in the case of certain worthless securities evidencing ownership. Prior to that Act, a deduction was authorized if certain securities evidencing ownership became worthless during the taxable year. See Section 23 (g) (2) and (3), Internal Revenue Code of 1939 (26 U. S. C. 1940 ed., Sec. 23 (g)). At the same time, deductions were authorized in the case of bad debts and certain worthless securities evidencing indebtedness only if such debts or securities were ascertained to be worthless and charged off within the taxable year. See Section 23 (k) (1), (2) and (3),

a loss from the sale or exchange of a capital asset. By limiting the bad debts which an individual might deduct as such to business bad-debts, and by requiring nonbusiness bad debts to be treated as capital losses, Congress in effect carved out of the general category of losses a particular class of losses, namely, nonbusiness bad debt losses, and expressly subjected them to capital loss limitations—just as it had previously done (in Section 23 (g) (2) and (3) and (k) (2) and (3)) with respect to debt and stock interests evidenced by securities. It is thus clear from the statutory pattern which emerged from the 1942 amendments that, irrespective of whether a nonbusiness bad debt loss might otherwise qualify for deduction in full under the general provisions of Section 23 (e) (2), *i. e.*, as a nonbusiness loss incurred in a transaction entered into for profit,[11] such a loss is deductible only as a capital loss by virtue of the special limitation provisions contained in Section 23 (k) (4).

Internal Revenue Code of 1939 (26 U. S. C.—1940 ed., Sec. 23 (k)). Upon adoption of the Revenue Act of 1942, the test in each case became whether the debt or security became worthless during the taxable year, the ascertainment of worthlessness and charge-off requirement (with an exception not relevant here) being eliminated.

[11] The determination whether a loss is a business or nonbusiness loss being substantially the same as the determination whether a debt is a business or nonbusiness debt (H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 77–78 (1942–2 Cum. Bull. 372, 431); Section 29.23 (k)–6, Treasury Regulations 111), a nonbusiness bad debt loss cannot, of course, be deducted as a business loss under Section 23 (e) (1). Nor, since a bad debt loss is obviously not a casualty or theft loss, can it be deducted under Section 23 (e) (3).

In *Spring City Co.* v. *Commissioner,* 292 U. S. 182, involving the pre-1942 statutory provisions, this Court, in disallowing a bad debt deduction claimed under the general loss provision, stated (p. 189), that "The making of the specific provision as to debts indicates that these were to be considered as a special class and that losses on debts were not to be regarded as falling under the preceding general provision." Similarly, the special capital loss provision of Section 23 (k) (4) added by the 1942 Act and dealing specifically with nonbusiness bad debt losses, rather than the general loss provision of Section 23 (e) (2), governs the extent of the deductibility of a nonbusiness bad debt loss.

Taxpayer erroneously assumes (Br. 6–7) that Section 23 (k) (4) was aimed merely at family and friendship transactions which purported to create debts but were actually gifts. No new legislation was needed to accomplish that purpose, for such transactions do not give rise to deductible debts at all. On the contrary, as is plain from the language of the section, it was intended to apply comprehensively to all "non-business" bad debt losses, irrespective of whether the lender or borrower (or guarantor) is an individual or a corporation or of whether they are related or unrelated by ties of family or friendship. Nor is there any warrant for taxpayer's further assumption (Br. 7–11) that Section 23 (k) (4) was not intended to apply to non-business bad debts arising by operation of law. Of course, not every obligation

necessarily represents an indebtedness.[12] But Section 23 (k) (4) by its very terms applies to any "nonbusiness debt", however it arises. (And see pp. 19–21, *infra.*)

Accordingly, even assuming as taxpayer contends (Br. 17–18) that he entered into a transaction for profit when he guaranteed repayment of the loans to his corporation, the loss resulting from the guaranty transaction is nonetheless subject to the capital loss limitations imposed by the special provisions of Section 23 (k) (4) if it represented a nonbusiness bad debt loss. Since there is no question that the loss was of a nonbusiness character (see n. 2, *supra,* p. 10), the narrow question which remains—and upon which this case turns—is whether the loss was, as both courts below held, a bad debt loss. If it was, then Section 23 (k) (4) applies and taxpayer is entitled only to a capital loss deduction.

C. *The loss in question was a bad debt loss*

The courts below correctly concluded that taxpayer's nonbusiness loss as guarantor was a bad debt loss subject to the capital loss limitations on deductibility contained in Section 23 (k) (4) of the Internal Revenue Code of 1939, *supra.* The correctness of their conclusion becomes apparent upon examination of (1) the nature of a guarantor's loss, (2) the tax treatment afforded such a loss long prior to the enact-

[12] Thus, *Hanes* v. *Commissioner*, 2 T. C. 213, to which taxpayer points (Br. 7–8) as allegedly illustrating an inconsistency in the Commissioner's position, did not involve a debt but merely an unadjudicated damage claim for fraud.

ment of Section 23 (k) (4), and (3) the subsequent legislation with respect to both bad debt losses generally and guarantors' bad debt losses in particular.

The principle is well established, both generally and in the State of Iowa,[13] that a guarantor who is required to make payment under his guaranty contract succeeds to the rights of the creditor by subrogation. The law implies a promise on the part of the principal debtor to reimburse the guarantor, and the guarantor's payment is treated not as extinguishing the debt but as merely substituting the guarantor for the creditor. *Aetna Life Ins. Co.* v. *Middleport,* 124 U. S. 534, 548; *United States* v. *Munsey Trust Co.,* 332 U. S. 234, 242; *Howell* v. *Commissioner,* 69 F. 2d 447 (C. A. 8th), certiorari denied, 292 U. S. 654; *American Sur. Co.* v. *State T. & S. Bk.,* 218 Iowa 1, 254 N. W. 338; *Randell* v. *Fellers,* 218 Iowa 1005; 252 N. W. 787; Brandt, *Suretyship & Guaranty* (3d ed.), Sec. 324; 24 *Am. Jur.,* Sec. 125. Accordingly, while a guarantor by entering into the guaranty contract and making payment thereunder puts himself in a position where he may sustain a loss, it is only if, and to the extent that, the debt which he acquires by subrogation is worthless that he actually sustains a loss. Thus, if the guarantor, having made payment under his guaranty contract, is able to recover in full from the principal debtor, he clearly suffers no loss at all. It follows, therefore, that any loss, the existence and extent of which is wholly and directly dependent

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[13] The guaranty contract was apparently executed and performed in Des Moines, Iowa. (R. 2-4.)

upon the worthlessness of a debt, should be attributed to the worthlessness of that debt, *i. e.*, should be considered a bad debt loss.[14]

Prior to the addition of Section 23 (k) (4) to the Internal Revenue Code of 1939, both the administrative and the judicial construction of the bad debt deduction provisions of the internal revenue laws had long recognized that a guarantor's loss is by its very nature a loss from the worthlessness of a debt. Thus, prior to the enactment of that section in 1942, when, as pointed out *supra* (pp. 14–15), the deduction of nonbusiness bad debt losses was first restricted, numerous administrative rulings and judicial decisions had been issued construing the statutory bad debt deduction provisions as covering guarantors' losses. See, for example, O. D. 556, 2 Cum. Bull. 137 (1920); A. R. R. 479, 5 Cum. Bull. 146 (1921); I. T. 2012, III-1 Cum. Bull. 158 (1924); I. T. 2025, III-1 Cum. Bull. 166 (1924); *Shiman* v. *Commissioner,* 60 F. 2d 65 (C. A. 2d); *Hamlen* v. *Welch,* 116 F. 2d 413 (C. A. 1st); *Gimbel* v. *Commissioner,* 36 B. T. A. 539; *Roberts* v. *Commissioner,* 36 B. T. A. 549; *Sharp* v. *Commissioner,* 38 B. T. A. 166; *Hovey* v. *Commissioner,* decided February 17, 1939 (1939 P-H B. T. A. Memorandum Decisions, par. 39,081); *Pierce* v. *Commis-*

[14] So long as payment of a debt is guaranteed by a solvent guarantor, the insolvency of the principal debtor obviously does not render the debt worthless. Consequently, if the debt which a guarantor acquires by subrogation becomes worthless, it necessarily becomes worthless in the hands of the guarantor rather than in the hands of the original creditor.

sioner, 41 B. T. A. 1261; *Whitcher* v. *Welch*, 22 F. Supp. 763 (Mass.).[15]

Moreover, in the light of this long-standing administrative and judicial construction of the statutory bad debt deduction provisions, Congress repeatedly reenacted those provisions without substantial change and without indicating any disagreement.[16] Nor did Congress indicate any intention to depart from this settled construction when in the Revenue Act of 1942, *supra*, it provided for capital loss treatment of an individual's nonbusiness bad debts. Accordingly, Congress ~~must be~~ deemed, under well-settled principles, to have approved this construction as a correct interpretation

[15] Similar decisions subsequently rendered include:
Ortiz v. *Commissioner*, 42 B. T. A. 173, reversed on another ground, *sub nom. Helvering* v. *Wilmington Trust Co.*, 124 F. 2d 156 (C. A. 3d), reversed (without discussion on this point), 316 U. S. 164; *Burnett* v. *Commissioner*, decided September 24, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42,528); *Ritter* v. *Commissioner*, decided October 9, 1946 (1946 P-H T. C. Memorandum Decisions, par. 46,237); *Greenhouse* v. *Commissioner*, decided August 30, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,250); *Est. of Rosset* v. *Commissioner*, decided December 30, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,346); *Watson* v. *Commissioner*, 8 T. C. 569; *Sherman* v. *Commissioner*, 18 T. C. 746; *Aftergood* v. *Commissioner*, 21 T. C. 60; *Stamos* v. *Commissioner*, 22 T. C. 885.

[16] The bad debt deduction provisions of earlier Revenue Acts were enacted in Section 214 (a) (7) of the Revenue Act of 1921, c. 136, 42 Stat. 227; Section 214 (a) (7) of the Revenue Act of 1924, c. 234, 43 Stat. 253; Section 214 (a) (7) of the Revenue Act of 1926, c. 27, 44 Stat. 9; Section 23 (j) of the Revenue Act of 1928, c. 852, 45 Stat. 791; Section 23 (j) of the Revenue Act of 1932, c. 209, 47 Stat. 169, Section 23 (k) of the Revenue Act of 1934, c. 277, 48 Stat. 680, Section 23 (k) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, Section 23 (k) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and Section 23 (k) of the Internal Revenue Code of 1939.

of the statute and to have intended that the bad debt loss provisions would continue to govern a taxpayer's losses as guarantor.[17] *Corn Products Co.* v. *Commissioner,* 350 U. S. 46, 52–53; *Commissioner* v. *Munter,* 331 U. S. 210, 215; *Crane* v. *Commissioner,* 331 U. S. 1, 8; *Commissioner* v. *Flowers,* 326 U. S. 465, 469; *Boehm* v. *Commissioner,* 326 U. S. 287, 291–292; *Douglas* v. *Commissioner,* 322 U. S. 275, 281.

Taxpayer relies chiefly upon recent decisions of some of the Courts of Appeals, disagreeing with those of the Tax Court, to the effect that guarantors' losses are not bad debt losses. See *Cudlip* v. *Commissioner,* 220 F. 2d 565 (C. A. 6th); *Pollak* v. *Commissioner,* 209 F. 2d 57 (C. A. 3d); *Ansley* v. *Commissioner,* 217 F. 2d 252 (C. A. 3d); *Edwards* v. *Allen,* 216 F. 2d 794 (C. A. 5th). As pointed out in the dissenting opinion in the *Cudlip* case, with which the court below agreed (R. 34), the reasoning in those cases will not withstand analysis. It is grounded upon three false assumptions.

First, it is assumed that no distinction should be made between a voluntary and an involuntary acquisition of a worthless debt, and it is accordingly con-

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[17] That Congress has consistently adhered to the treatment of guarantors' losses as bad debt losses is further demonstrated by its subsequent legislation dealing specifically with the deduction of an individual's losses as guarantor of noncorporate obligations. Thus, by Section 166 (f) of the Internal Revenue Code of 1954 (26 U. S. C. 1952 ed., Supp. II, Sec. 166), Congress provided not only that such guarantors' losses may be deducted in full if they meet certain prescribed qualifications but also that they shall be deducted as bad debts. The significance of limiting full deduction to cases involving noncorporate obligations is discussed, *infra*, pp. 29–30.

cluded that the worthless debt which a guarantor involuntarily acquires by subrogation upon being required to make payment under his guaranty contract is no debt at all. This assumption loses sight of the very basis for refusing to treat a voluntary acquisition of a worthless debt as the acquisition of a valid debt. The reason for such treatment is that a trans action in which one voluntarily advances money to another without any expectancy of repayment involves, in reality, no debt at all, but a gratuity. *W. F. Young, Inc.* v. *Commissioner,* 120 F. 2d 159 (C. A. 1st); *American Cigar Co.* v. *Commissioner,* 66 F. 2d 425 (C. A. 2d), certiorari denied, 290 U. S. 699; *Reading Co.* v. *Commissioner,* 132 F. 2d 306 (C. A. 3d), certiorari denied, 318 U. S. 778. No such gratuity is involved in the case of a guarantor whose payment to the creditor is made not voluntarily but because his contractual obligation requires it, and whose loss arises, not because he is making a gift to the primary obligor but because the latter is unable to repay the debt. See 5 Mertens, *Law of Federal Income Taxation* (1953 Rev.), Sec. 30.41, p. 412.

Second, it is assumed (at least in the *Allen* case) that the debt which a guarantor acquires by subrogation does not originate until its acquisition by the guarantor, and it is argued, therefore, that such a debt cannot "become" worthless within the taxable year, within the meaning of Section 23 (k), because it is worthless from its origin. This refined argument misconceives the basis of the doctrine of subrogation, under which payment by a guarantor is treated not

as creating a new debt and extinguishing the original debt owed by the principal debtor to the creditor, but rather as preserving the original debt and merely substituting the guarantor for the creditor. Unless that fundamental concept is repudiated, it is clear that the original debt which a guarantor acquires by subrogation becomes worthless only after he acquires it. The debt certainly was not worthless at its inception, and so long as it remains enforceable against the guarantor, as in this case, it is not worthless to the man who owns it, i. e., the creditor. It becomes worthless only if and when its new owner, i. e., the guarantor, pays the debt and succeeds to the rights of the creditor, and then or thereafter the debt becomes non-collectible against the primary obligor. The fact that a debt may become worthless at the very instant the guarantor acquires it does not negate the existence of the debt.

Third, it is assumed that the nature of the issue presented and the statutory bad debt provisions involved here are the same as in *Eckert* v. *Burnet*, 283 U. S. 140, and that consequently this Court's holding in that case requires a decision in favor of taxpayer here. The issue decided in *Eckert*, however, as this Court later explained in *Helvering* v. *Price*, 309 U. S. 409, related merely to the year in which a taxpayer using the cash method of accounting was entitled to a deduction, either as a bad debt or as a loss not involving a bad debt. The taxpayer there had made no cash payment as guarantor in the taxable year before the Court but had merely substituted his note

on which he was primarily liable for the principal debtor's notes upon which he was secondarily liable. While the Court indicated that the taxpayer might be entitled to a deduction in a later year, when he paid his note, it did not hold that such a deduction would not be a bad debt deduction. Indeed, this Court's only reference in *Eckert* to the statutory bad debt provisions there involved consisted of repeating with approval a statement, which Judge Learned Hand had made in that case in the court below and which he subsequently explained in *Shiman* v. *Commissioner,* 60 F. 2d 65, 66–67 (C. A. 2d), to the effect that, since any debt which Eckert acquired was worthless when he acquired it, there was nothing to charge off. Taxpayer's reliance on that statement is entirely misplaced, since it related to the pre-1942 statutory provision then in effect requiring that a debt in order to be deductible be ascertained to be worthless and charged off within the taxable year (raising a question whether such debt must have been previously carried on the taxpayer's books as a valuable asset), a requirement which, as already pointed out (n. 10, *supra,* pp. 14–15), was subsequently eliminated by the 1942 Act.

Because of the erroneous reasoning upon which the *Cudlip, Pollak,* and like cases relied upon by taxpayer rest, the court below properly declined to follow them. The correct view, we submit, is that expressed in the dissenting opinion in the *Cudlip* case,

approved by the court below. (R. 34.) As Judge Stewart there stated, in part (pp. 570–571):

> As recognized in the majority opinion, it is hornbook law that when a guarantor is compelled to pay the principal creditor, he becomes by operation of law subrogated as a creditor of the principal debtor. In the nature of things, the debt which the guarantor thus acquires is usually worthless at the time of its acquisition. Yet, until the Pollak and Allen cases, and today's decision in this case, the debt so arising has consistently been considered nonetheless deductible as a bad debt, although it became worthless immediately upon its ripening from a secondary obligation into a debt.

The decision of the Second Circuit in *Fox* v. *Commissioner*, 190 F. 2d 101, upon which taxpayer also relies (Br. 13), is inapposite. In issue in that case was a payment which the taxpayer as guarantor was required to make on an indebtedness of her deceased husband, whose estate was insolvent and whose executors had been discharged four years prior to the time such payment was made. Accordingly, when the widow made her payment as guarantor, there was, technically as well as realistically, no principal debtor in existence against whom she could acquire any rights by subrogation. In holding that under those circumstances her loss was not a bad debt loss subject to capital loss limitations, the court, referring to *Pierce* v. *Commissioner*, 41 B. T. A. 1261, and *Gimbel* v. *Commissioner*, 36 B. T. A. 539, stated (p. 105) that its holding did "no violence to the theory that a debt

might arise upon payment by a guarantor where the principal debtor remains still in existence."

In an effort to assimilate the situation here to that presented in *Fox*, taxpayer argues (Br. 12) that the corporation whose debt he guaranteed had disposed of its assets and been liquidated before he made the guaranty payments. The undisputed fact remains, however, that the corporation had not been dissolved but was still in existence at the time. And even if the corporation had been dissolved, it would have remained alive, under the law of Iowa, for the purpose of paying its debts. 28 Iowa Code Annotated § 491.56; *Wisconsin & Arkansas Lumber Co.* v. *Cable*, 159 Iowa 81, 91, 140 N. W. 211. Moreover, where as here the principal debtor is a corporation of which the guarantor is the controlling stockholder, so that the continued existence of the principal debtor is within the control of the guarantor, the tax consequence surely ought not to depend upon whether the guarantor chooses to liquidate and dissolve the insolvent corporation before or after making the guaranty payment.[18]

At any rate, whether or not a guarantor's loss is deductible in full rather than as a capital loss in the exceptional situation presented in the *Fox* case—death of the principal debtor and closing of the administration of his insolvent estate before the guarantor is

[18] Significantly, Section 166 (f) of the Internal Revenue Code of 1954 (quoted in footnote 20, p. 29, *infra*), not only treats a guarantor's payment as a bad debt loss, but authorizes its deduction in full (*i. e.*, as a business rather than a nonbusiness bad debt loss) only where the guaranty is of a noncorporate

called upon to make payment—is a question not here presented and need not here be decided. In the *Fox* case the court had before it an unusual set of facts. However, in the ordinary case, like this one, where the insolvent principal debtor (or its assignee or successor) is in existence when the guaranted payment is made, it is clear that the statute requires the guarantor's loss to be treated as a bad debt loss.

D. *Treatment of the loss as other than a bad debt loss would render the applicability of Section 23 (k) (4) dependent upon the form rather than the substance of the transaction resulting in the loss*

Quite apart from the foregoing, there are important practical considerations which impel the conclusion that Congress intended to treat losses stemming from the guarantee of a corporate debt as bad debt losses subject to the capital loss limitations of Section 23 (k) (4). Congress has provided for capital loss treatment not only of worthless stock losses (Section 23 (g) (2) and (3)), but also of losses resulting from loans to a corporation, whether or not the loan is evidenced by a debt security (Section 23 (k) (2), (3) and (4)). And it made no distinction between lenders and guarantors. There is no real or economic difference—and consequently there should be none for tax purposes [19]—between the loss of an investment made in the form of a direct loan to a corporation and

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[19] Cf. *Higgins* v. *Smith*, 308 U. S. 473; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Gregory* v. *Helvering*, 293 U. S. 465.

one made indirectly in the form of a guaranteed bank loan, especially where as here the guarantor is the dominant stockholder of the corporation.

No valid reason appears, and none is suggested by taxpayer, for imputing to Congress an intent to single out indirect loans, in the form of a guarantee or endorsement of a third party's loan to the corporation, for preferential tax treatment over other types of investments in an unsuccessful corporate enterprise. Even if the legislative intent in this respect were not as plain as it is, "A desire for equality among taxpayers is to be attributed to Congress, rather than the reverse." *Colgate* v. *United States*, 320 U. S. 422, 425. As Judge Stewart pointed out in his dissenting opinion in the *Cudlip* case (p. 572):

> Had the petitioner made the necessary additional investment in the conventional form of subscribing for stock, his loss upon the failure of the corporation would have been a capital loss, § 23 (g) (2), I. R. C. Had he made the investment in the form of a loan to the corporation evidenced by an instrument bearing interest coupons, his loss would likewise have been a capital loss, § 23 (k) (2), I. R. C. Had he made the additional investment in the form of an ordinary loan to the corporation, his loss would likewise have been a capital loss, § 23 (k) (4) I. R. C., Commissioner of Internal Revenue v. Smith, supra.
>
> Because the petitioner happened instead to risk his money by guaranteeing the corporation's bank loans, the court now holds that the petitioner may take an ordinary loss, deductible

> in full from his ordinary income. Yet from the petitioner's viewpoint, the situation would have been precisely the same had he himself borrowed the money and then lent it to the corporation. It therefore seems to me that the result reached by the court in this case is significantly unrealistic.
>
> From now on an investor in this Circuit need not be content with a capital loss if he loses his risk capital. If only he can make his investment in the form of a guaranty, his loss will be deductible in full from his ordinary income if the venture is unsuccessful.

The Congressional intent to preclude deduction in full of losses like that here involved, and to treat them as capital losses from nonbusiness bad debts, has been confirmed by and carried over into the Internal Revenue Code of 1954. Section 166 (f) of that Code provides for treatment as a business "bad debt" (*i. e.,* deduction in full) of payments made by a taxpayer as a "guarantor, endorser, or indemnitor," but explicitly confines such treatment to the guaranty of a "noncorporate obligation."[20] Thus Congress in

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[20] That section provides:

"A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment."

the 1954 Code not only expressly recognized that losses sustained by guarantors constitute bad debt losses, but made certain that they are subject to capital loss limitations if they result from the guaranty of a corporate debt.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court of Appeals is correct and should be affirmed.

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APPENDIX

nternal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

* * * * *

(g) *Capital Losses.*—

(1) *Limitation.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

(2) *Securities becoming worthless.*—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) [As amended by Sec. 123 (a) (2) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of securities.*—As used in paragraph (2) of this subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

* * * * *

(k) [As amended by Sec. 124 (a) of the Revenue Act of 1942, *supra*] *Bad Debts.*—

(1) [As amended by Sec. 113 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *General rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a nonbusiness debt, as defined in paragraph (4) of this subsection.

(2) *Securities becoming worthless.*—If any securities (as defined in paragraph (3) of this subsection) become worthless within the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, as defined in section 104, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) *Definition of securities.*—As used in paragraphs (1), (2), and (4) of this subsection the term "securities" means bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form.

(4) *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(d) [As amended by Sec. 150 (c) of the Revenue Act of 1942, supra] *Limitation on Capital Losses.*—

* * * * *

(2) *Other taxpayers.*—In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the net income of the taxpayer of [or] [sic] $1,000, whichever is smaller. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.23 (e)-1. *Losses by Individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23 (g) and 117, relating to capital losses; section 23 (h), relating to wagering losses; section 24 (b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118 relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113 (b).

For special provisions with respect to war losses, see section 127.

* * * * *

A loss on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible. If, however, property so purchased or constructed is prior to its sale rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss from the sale of the property, computed as provided in section 111, is, subject to the limitations provided in section 117, an allowable deduction in an amount not to exceed the excess of the value of the property at the time it was appropriated to income-producing purposes (with proper adjustment for depreciation) over the amount realized from the sale.

* * * * *

Sec. 29.23 (g)–1. *Capital Losses.*—Section 23 (g) provides in effect that deductions allowed to individuals under section 23 (e) and to corporations under section 23 (f) for losses sustained on the sale or exchange of a capital asset shall be limited in amount to the extent provided in section 117. * * *

* * * * *

Sec. 29.23 (k)–6 [As amended by T. D. 5458, 1945–1 Cum. Bull. 45]. *Non-business Bad Debts.*—In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be

treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this subdivision applicable in the case of a loss resulting from a security as defined in section 23 (k) (3). A non-business debt is a debt other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23 (k) (3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23 (e) is "incurred in trade or business" under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purposes of this section.

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